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ECONOMIC AND LEGAL ASPECTS OF FOREIGN DIRECT INVESTMENT

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LIST OF ABBREVIATIONS

ACP	AFRICAN, CARIBBEAN AND PACIFIC
ADR	ALTERNATIVE METHODS OF DISPUTE RESOLUTION
ALADI	LATIN AMERICAN INTEGRATION ASSOCIATION (ASOCIACIÓN LATINOAMERICANA DE INTEGRACIÓN)
APEC	ASIA-PACIFIC ECONOMIC COOPERATION
ASEAN	ASSOCIATION OF SOUTHEAST ASIAN NATIONS
BIP	BUREAU OF INVESTMENT PROMOTION
BIT	BILATERAL INVESTMENT TREATY
BOI	BOARD OF INVESTMENT
BUILD	BOARD OF INVESTMENT UNIT FOR INDUSTRIAL LINKAGE DEVELOPMENT
CAN	ANDEAN COMMUNITY (COMUNIDAD ANDINA)
CARICOM	CARIBBEAN COMMUNITY
CARIFORUM	CARIBBEAN FORUM OF AFRICAN, CARIBBEAN AND PACIFIC STATES
CDS	CORPORATE DEVELOPMENT SUPPORT
CEE	CENTRAL AND EASTERN EUROPE
CEMAC	ECONOMIC AND MONETARY COMMUNITY OF CENTRAL AFRICA (COMMUNAUTÉ ÉCONOMIQUE ET MONÉTAIRE DE L'AFRIQUE CENTRALE)
CEPGL	ECONOMIC COMMUNITY OF THE GREAT LAKES COUNTRIES (COMMUNAUTÉ ÉCONOMIQUE DES PAYS DES GRANDS LACS)
CERES	COALITION FOR ENVIRONMENTALLY RESPONSIBLE ECONOMIES
CIS	COMMONWEALTH OF INDEPENDENT STATES
COMESA	COMMON MARKET FOR EASTERN AND SOUTHERN AFRICA
CU	CUSTOMS UNION
DPP	DISPUTE PREVENTION POLICY
DSA	DISPUTE SETTLEMENT ARRANGEMENT
DTT	DOUBLE TAXATION TREATY
ECOWAS	ECONOMIC COMMUNITY OF WEST AFRICAN STATES
ECJ	EUROPEAN COURT OF JUSTICE
ECT	ENERGY CHARTER TREATY
EEC	EUROPEAN ECONOMIC COMMUNITY
EHC	EGYPTIAN HOTEL COMPANY
EIA	ECONOMIC INTEGRATION AGREEMENT
EPA	ECONOMIC PARTNERSHIP AGREEMENT
EPZ	EXPORT PROCESSING ZONE
EU	EUROPEAN UNION
FDI	FOREIGN DIRECT INVESTMENT
FTA	FREE TRADE AGREEMENT
FTAA	FREE TRADE AREA OF THE AMERICAS
GATS	GENERAL AGREEMENT ON TRADE IN SERVICES
GATT	GENERAL AGREEMENT ON TARIFFS AND TRADE
GCC	GULF COOPERATION COUNCIL
GDP	GROSS DOMESTIC PRODUCT
GFCF	GROSS FIXED CAPITAL FORMATION
HCM	HOME COUNTRY MEASURE
HCOM	HOST COUNTRY OPERATIONAL MEASURE
ICC	INTERNATIONAL CHAMBER OF COMMERCE
ICJ	INTERNATIONAL COURT OF JUSTICE
ICSID	INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
IDA	INDUSTRIAL DEVELOPMENT AGENCY

LIST OF ABBREVIATIONS

IIA	INTERNATIONAL INVESTMENT AGREEMENT
ILO	INTERNATIONAL LABOUR ORGANIZATION
IMF	INTERNATIONAL MONETARY FUND
IPA	INVESTMENT PROMOTION AGENCY
IPPA	INVESTMENT PROMOTION AND PROTECTION AGREEMENT
IPR	INTELLECTUAL PROPERTY RIGHT
IT	INFORMATION TECHNOLOGY
LDC	LEAST DEVELOPED COUNTRY
M&A	MERGER AND ACQUISITION
MAI	MULTILATERAL AGREEMENT ON INVESTMENT
MERCOSUR	SOUTHERN COMMON MARKET (MERCADO COMÚN DEL SUR)
MFN	MOST-FAVOURED-NATION
MIGA	MULTILATERAL INVESTMENT GUARANTEE AGENCY
MNC	MULTINATIONAL CORPORATION
NAFTA	NORTH AMERICAN FREE TRADE AGREEMENT
NGO	NON-GOVERNMENTAL ORGANIZATION
NT	NATIONAL TREATMENT
ODA	OFFICIAL DEVELOPMENT ASSISTANCE
OECD	ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
OEM	ORIGINAL EQUIPMENT MANUFACTURE
PCA	PERMANENT COURT OF ARBITRATION
PCIJ	PERMANENT COURT OF INTERNATIONAL JUSTICE
PSA	PRODUCTION-SHARING AGREEMENT
PTIA	PREFERENTIAL TRADE AND INVESTMENT AGREEMENT
R&D	RESEARCH AND DEVELOPMENT
REIO	REGIONAL ECONOMIC INTEGRATION ORGANIZATION
RTA	REGIONAL TRADE AGREEMENT
SADC	SOUTHERN AFRICAN DEVELOPMENT COMMUNITY
SCM	SUBSIDIES AND COUNTERVAILING MEASURES
SEE	SOUTH-EAST EUROPE
SGS	SOCIÉTÉ GÉNÉRALE DE SURVEILLANCE
SME	SMALL AND MEDIUM-SIZED ENTERPRISE
SWOT	STRENGTHS, WEAKNESSES, OPPORTUNITIES AND THREATS
TNBC	TANZANIA NATIONAL BUSINESS COUNCIL
TNC	TRANSNATIONAL CORPORATION
TOT	TRANSFER OF TECHNOLOGY
TRIMS	TRADE-RELATED INVESTMENT MEASURES
TRIPS	TRADE-RELATED ASPECTS OF INTELLECTUAL PROPERTY RIGHTS
UDEAC	CUSTOMS AND ECONOMIC UNION OF CENTRAL AFRICA (UNION DOUANIÈRE ET ÉCONOMIQUE DE L'AFRIQUE CENTRALE)
UK	UNITED KINGDOM
UNCITRAL	UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW
UNCTAD	UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
US	UNITED STATES
WAIPA	WORLD ASSOCIATION OF INVESTMENT PROMOTION AGENCIES
WAEMU	WEST AFRICAN ECONOMIC AND MONETARY UNION
WTO	WORLD TRADE ORGANIZATION

MODULE 1

Economic aspects of Foreign Direct Investment

INTRODUCTION TO MODULE 1

It is widely recognized that investment is an important element of economic activity and one of the key factors fostering growth both at the firm and at the country level.

In the context of a globalizing world economy, enterprises increasingly seek new markets, resources and opportunities of improving the productive efficiency outside their home countries through foreign direct investment (FDI) – investment in production abroad made with the intention of exercising a lasting influence on the production activities that result. Such cross-border investment is an accelerating phenomenon: FDI inflows grew from US$13 billion in 1970 to US$208 billion in 1990 and reached US$1,387 billion in 2000. Global FDI reached a new record high in 2007 amounting to US$1,979 billion. Due to the turmoil in the financial markets, however, FDI inflows fell by 14 per cent in 2008 compared with the previous year. The transnational dimension of companies becomes larger as they merge with, or buy, companies in other countries, or undertake new investment abroad. Transnational corporations (TNCs) are nowadays responsible for about two thirds of global financial flows to developing countries.

From the perspective of developing countries, foreign investment is a source of foreign capital adding to internal resources and international aid to finance their development. Foreign investment can help fill the gap that developing countries often face between the resources needed to finance the desired rate of investment and those generated by their actual rate of domestic savings. Moreover, FDI, which is not merely capital but a package of resources, can in addition bring wider benefits to the host economy, such as the transfer of technology, increased employment, skills upgrading or improved export performance. These potential contributions are of particular interest to host countries seeking to accelerate their development process by complementing their domestic technological and other capabilities by those that TNCs bring.

Nevertheless, FDI also involve certain risks, both for the investor and for the host country. For investors, firm-level risks of an economic nature are inherent to a market economy and enterprises have developed strategies aimed at reducing risks. But there are risks for them of a non-economic nature, deriving from governmental action. Governments also seek to limit potential risks related to FDI in terms of the impact on the country's economy, while trying to enhance its benefits. Thus, the importance of FDI can be assessed not only in terms of volume or economic impact, but also in terms of national and international concerns about it. For instance, the concern about improving the conditions and limiting the risks in the relationship between foreign investors and the host country has lead to a spectacular proliferation of investment-related international treaties: at the bilateral level alone, the number of investment treaties increased from 385 in 1989 to 2,676 in 2008. In 2008 alone, 59 additional investment treaties were ratified – among which 46 were in developing countries and 38 were in developed countries.

The combination of risks and opportunities offered by a particular country influences the decision to invest in that country. Economic factors such as access to natural resources, skilled labour, market size or labour costs, together with other factors related to the host country's policy framework and business facilitation measures can all play a role in a TNC's choice of an investment location. They are locational determinants that define a country's investment environment, and include international investment agreements (IIAs) which are the subject of Module 3 of this teaching material.

This module begins by explaining and defining various concepts related to foreign investment (theme 1); it proceeds to present long-term trends in, and current patterns of international production and FDI (theme 2); it then examines the determinants of FDI, focusing in particular on locational determinants or host-country factors influencing the location of FDI (theme 3); and finally analyzes the economic impact of FDI, focusing on developing host countries and key aspects of their development process (theme 4). The main source of information and analysis used in considering all these issues is UNCTAD's annual publication, the World Investment Report (WIR).

Theme 1

Foreign Direct Investment and transnational corporations: concepts, definitions and measurement

INTRODUCTION

It is important to understand basic concepts and measures related to foreign direct investment and transnational corporations in order to further study and analyze the economic and policy aspects of FDI.

FDI can be defined as investing in a foreign location and engaging in economic activity there. Such investment is characterized by cross-border control and the investor's involvement in the management of the use of resources that have been invested. TNCs are firms that control assets in their home country as well as at least one other country, usually by owning a certain minimum stake in the capital stock. The impressive growth of FDI in the past few decades and the growing importance of FDI as a form of external finance in developing countries reflect not only the fact that firms increasingly find benefits in expanding their production and other economic activities internationally but also that host developing countries see potential advantages in FDI over other forms of international investment. Firms engaged in FDI establish foreign affiliates under their control in host economies, creating TNC systems comprising parent companies and foreign affiliates. Foreign affiliates may be wholly, majority, or minority owned by their parent companies.

There are two main modes of FDI entry into a host economy: greenfield investment or investment in newly established enterprises, and mergers and acquisitions (M&As). TNCs choose one or the other depending on their industry, objectives and strategies regarding FDI and host-country conditions.

The most common measures of FDI are flows and stocks. FDI inflows and outflows of countries as measured for the balance of payments purpose relates to capital transactions between direct investors (primarily TNC parent enterprises) and their affiliates abroad (defined in terms of having a minimum ownership of host-country enterprises) each year. FDI flows have three components: equity capital, reinvested earnings and intra-company loans. The way in which these components are defined and measured in statistics is important for understanding FDI flow data and analysis based on it. FDI stock measures the accumulated value of capital owned by parent firms in their foreign affiliates; data on stocks are derived from company surveys or as cumulative totals of FDI flows. For several purposes, particularly for understanding the role and significance of FDI and TNC activity for host and home countries, data on variables such as sales, employment and exports by foreign affiliates and parent TNCs are more revealing than those on flows and stocks of FDI, but their availability is much more limited than that of data on FDI flows.

At the end of this theme, students should be able to:

- Understand the concepts of investment and foreign direct investment;
- Define TNCs and distinguish between the different types of foreign affiliates;
- Understand the differences between FDI and portfolio investment;
- Understand the main entry modes of FDI;
- Understand the main components included in the measurement of FDI flows and the nature and sources of FDI flow data; and
- Understand how FDI stock and other variables related to TNC activity are measured and the nature and sources of data related to them.

HANDBOOK

1 Concepts of investment

In a broad sense, investment is usually understood as a sum of money or other resources (including, e.g. knowledge or time) spent with the expectation of getting a future return from it. Investment may, however, be viewed more narrowly along different dimensions, depending upon the context and purpose. The three main approaches to the concept of investment are the following:

(a) In macro-economics and national accounts, investment means expenditure on new capital goods (goods that are not consumed but instead used in future production), including factory buildings. Such investment is the source of new employment and economic growth. Examples: production of industrial machinery, building a factory, building a ship for the transport of goods.

(b) In finance, investment refers to the purchase or ownership of a financial asset with the expectation of a future return either as income (such as dividends), or as capital gain (such as a rise in the value of the stock). Example: buying shares of an enterprise on a stock market.

(c) Legal definitions of investment, found in laws and legal agreements, focus on the issue of property, notwithstanding the productive or financial nature of the investment, unless specific limitations are made. Broad definitions in international agreements, for instance, may cover any kind of asset that belongs to a foreign enterprise or an individual. Such definitions would encompass the two forms of investment mentioned above, adding to them non-profit private assets. Definitions in laws or legal agreements can be very different, broad or narrow, depending on the type and the purpose of the legal instrument. They do not serve to shape the concept of investment, but to establish the scope of assets covered by a legal instrument.

Investment by private sector entities is usually undertaken with the expectation of profit. In the first case mentioned above it involves an addition to the firm's productive capacity. In the second case it may or may not increase this capacity. It does increase when the financial assets purchased by investors are newly issued by firms to raise funds to create productive capacity. It does not when assets change hands from one owner to another. Acquisitions of assets for non-profit purposes, not used in production (for instance, buying a house) are not considered investment.

FDI encompasses the first (national accounts) approach and some elements of the second (financial) approach. As a concept, certain types of FDI coincide with national accounts investment – expenditures on capital goods and factory buildings by foreign enterprises in an economy do not differ from similar expenditures by domestic companies. Analogously, the production of goods and services by foreign enterprises can be measured as their value added, constituting part of Gross Domestic Product (GDP). Differences arise, however, when we consider the entry of foreign investors in a host country, which can take place through a new, so-called "greenfield" investment (a national accounts concept) or through the acquisition of an already existing company (a concept of financial investment).

2 Foreign Direct Investment: concept and definitions

Firms and individuals may invest and hold assets in countries other than their home country in more than one way. When an investor obtains a lasting or controlling interest in a foreign entity, typically an enterprise created or acquired by the investor, the investment is known as a foreign direct investment. For practical purposes this lasting interest is generally assumed if the equity stake of the foreign investor is at least 10 per cent. Definitions of FDI tend to vary across countries and organizations (see boxes 1 to 4).

Control of or a “lasting interest in” – as in the International Monetary Fund's (IMF) definition – an enterprise by a foreign investor is central to the concept of FDI, distinguishing it from other types of international investment. The concept has evolved along with an increased understanding of activities of TNCs or multinational corporations (MNCs), which account for most FDI. Firms engage in FDI in order to expand, their production outside the national boundaries of their home countries, for instance, and as a result become transnational (or multinational) corporations in the process. To produce, TNCs need control to decide what is produced, with what technology, where, etc. For many years it was thought that majority ownership was the only source of control of one enterprise over another, however, with time this assumption has become less. First, it has been observed that in many cases minority ownership can be sufficient to exercise control, and second, certain types of agreements (such as franchising agreements or management contracts) can also be a source of control strong enough to allow managing firms to make production decisions, giving rise to so-called "non-equity" forms of FDI. International production of TNCs, such as McDonalds or transnational hotel chains, is largely based on control through non-equity forms (see below).

Box 1

UNCTAD experiences with varying FDI definitions – a summary

UNCTAD utilizes a balance-of-payments definition of FDI, thus following IMF and the Organisation for Economic Co-operation and Development (OECD) definitions (boxes 2 and 3). Nevertheless, the organization has dealt with different definitions of FDI from country applications. Three important characteristics of FDI definitions, which are elaborated on below, give an impression of the existing differences in definitions across countries.

Components of FDI

The components of FDI are equity capital, reinvested earnings and other capital (mainly intra-company loans). As countries do not always collect data for each of those components, reported data on FDI is not fully comparable across countries. In particular, data on reinvested earnings, the collection of which depends on company surveys, is often unreported by many countries.

The threshold equity ownership

Countries differ in the threshold value for foreign equity ownership which they take as evidence of a direct investment relationship. This is the level of participation at or above which the direct investor is normally regarded as having an effective say in the management of the enterprise involved. The threshold value usually applied for FDI is 10 per cent. For data on the operations of TNCs, this percentage ranges between 10 and 50. Some countries do not specify a threshold point, but rely entirely on other evidence, including the companies´ own assessments as to whether the investing firm has an effective voice in the foreign business in which it has an equity stake. The quantitative impact of differences in the threshold value used is relatively small, due to the large proportion of FDI which is directed at majority owned foreign affiliates.

Defining a controlling interest and treatment of non-equity forms of investment

Other than having an equity stake in an enterprise, there are many other ways in which foreign investors may acquire an effective voice. These include subcontracting, management contracts, turnkey arrangements, franchising, leasing, licensing and production-sharing. A franchise (a firm to which business is subcontracted) or a company which sells most of its production to a foreign firm through means other than an equity stake are not usually collected although some countries have begun to contemplate doing so. For example, the OECD treats financial leases between direct investors and their branches, subsidiaries or associates as if they were conventional loans – such relationships will therefore be included in its revised definition of FDI.

Source: UNCTAD (2008).

The expansion of TNC activity worldwide since the early 20th century led to a growing interest in FDI as a form of international resource flow as well as a basis for the organization of production activity across national borders. Previously, interest focused first on international investment in the form of cross-border bank lending and later on portfolio investment. The rapid growth of FDI and its growing importance as a source of external finance as well as other resources to developing countries (discussed in Module 1, theme 2) in the past two decades has further increased interest in FDI and the international activities associated with it.

FDI is distinguished from other forms of international investment by two characteristics (Dunning, 1993: 5):

- All international investments are made outside the home country (country of residence) of the investing company, but FDI (distinctive from other forms) is made inside the investing firm. Control over the use of the resources transferred remains with the investor, allowing him/her to make investment and production decisions.

- While all investments involve the transfer of capital across borders, FDI involves, in addition to capital, other assets and resources, such as technology, management and other skills, access to markets, entrepreneurship, etc.

Thus, FDI involves more than just the flow of capital to the host country – it is a package of assets and resources, which are many times resources much needed by host countries for their growth and development. It also involves control of the (production) activity by the foreign investor in host countries. The factors giving rise to FDI as well as determining its location in different host countries are discussed in Module 1, theme 3 (determinants of FDI).

Since FDI involves control of (or lasting interest in) the enterprise abroad in which investment takes place, it might be expected that FDI would involve a high degree of ownership by the investor. The dominant current definitions of FDI – prescribed by the IMF for balance-of-payments compilations of data on flows of FDI (box 2) and income related to FDI, and a very similar one adopted by the OECD (box 3) – are formulated in terms of the direct investor having a lasting interest, i.e. a long-term relationship and a significant degree of influence on the management of the direct investment enterprise abroad; but they prescribe a relatively low threshold of ownership (10 per cent or more) as the basis for identifying foreign direct investors and the corresponding direct investment enterprises abroad. However, it has been noted that the actual criteria used by countries to identify FDI enterprises (for data gathering purposes, for instance) may deviate from those prescribed in the IMF and the OECD definitions (box 4).

Box 2

IMF definitions of FDI and related concepts

Direct investment is the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy. (The resident entity is the direct investor and the enterprise is the direct investment enterprise.) The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. Direct investment comprises not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated.

Direct investment enterprise is (...) an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10 per cent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise).

Direct investors may be individuals; incorporated or unincorporated private or public enterprises; associated groups of individuals or enterprises; governments or government agencies; or estates, trusts, or other organizations that own (...) direct investment enterprises in economies other than those in which the direct investors reside. The members of an associated group of individuals or enterprises are, through their combined ownership of 10 per cent or more, deemed to have an influence on management that is similar to the influence of an individual with the same degree of ownership.

Source: IMF (1993: 86-87).

Box 3

OECD definitions of FDI and related concepts

Foreign direct investment reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the enterprise. The direct or indirect ownership of 10 per cent or more of the voting power[1] of an enterprise resident in one economy by an investor resident in another economy is evidence of such a relationship. Some compilers may argue that in some cases ownership of as little as 10 per cent of the voting power may not lead to the exercise of any significant influence while on the other hand, an investor may own less than 10 per cent but have an effective voice in management. Nevertheless, the recommended methodology does not allow any qualification of the 10 per cent threshold and recommends its strict application to ensure statistical consistency across countries. Direct investment includes the initial equity transaction that meets the 10 per cent threshold and all subsequent financial transactions and positions between the direct investor and the direct investment enterprise, as well as qualifying FDI transactions and positions between incorporated and unincorporated.

[1] In general ordinary shares are the same as voting power. However, there may be instances that the voting power is not represented by ordinary shares. In such cases, compilers must determine the voting power.

Box 3

OECD definitions of FDI and related concepts

A foreign direct investor is an entity (an institutional unit) resident in one economy that has acquired, either directly or indirectly, at least 10 per cent of the voting power of a corporation (enterprise), or equivalent for an unincorporated enterprise, resident in another economy. A direct investor could be classified to any sector of the economy and could be any of the following: (i) an individual; (ii) a group of related individuals; (iii) an incorporated or unincorporated enterprise; (iv) a public or private enterprise; (v) a group of related enterprises; (vi) a government body; (vii) an estate, trust or other societal organisation; or (viii) any combination of the above.

In the case where two enterprises each own 10 per cent or more of each other's voting power, each is a direct investor in the other.

A **direct investment enterprise** is an enterprise resident in one economy and in which an investor resident in another economy owns, either directly or indirectly 10 per cent or more of its voting power if it is incorporated or the equivalent for an unincorporated enterprise.

The numerical threshold of ownership of 10 per cent of the voting power determines the existence of a direct investment relationship between the direct investor and the direct investment enterprise. An ownership of at least 10 per cent of the voting power of the enterprise is regarded as necessary evidence that the investor has sufficient influence to have an effective voice in its management. In contrast to some other statistical measures such as those on the activities of MNEs, direct investment does not require control by the investor (i.e. more than 50 per cent owned by the investor and/or its related enterprises). Direct investors may have direct investment enterprises in one economy or in several economies.

Source: OECD (2008: 40-42).

As mentioned earlier, foreign firms may also be able to control or exercise effective voice in the management of enterprises in a host country through non-equity arrangements of some kind. Non-equity or contractual agreements vary in the nature of the relationship between the parties involved. Some of them, such as franchising (popular in fast food, car rentals and retail trade), management contracts (popular in the hotel industry) and partnership agreements (popular in business consultancy and legal services) may give companies providing the brand names and proprietary technology (including soft technology such as organizational and managerial practices and other knowledge) to host-country enterprises sufficient voice in management and control over the latter for them to be considered direct investors engaged in FDI. For practical purposes of data collection, the IMF and the OECD definitions of FDI do not, however, include non-equity forms of FDI within their scope (box 5). FDI is generally conceived of as involving a minimum equity share by the investor.

Box 4

Other approaches to identifying FDI

Although not recommended by the OECD, some countries may still feel it necessary to treat the 10 per cent cut-off point in a flexible manner to fit the circumstances. In some cases, ownership of 10 per cent of ordinary shares or voting power may not lead to the exercise of any significant influence while, on the other hand, a direct investor may own less than 10 per cent but have an effective voice in the management. The OECD does not recommend any qualifications to the 10 per cent rule, consequently, countries that choose not to follow the 10 per cent rule in all cases should identify, where possible, the aggregate value of transactions not falling under the 10 per cent cut-off rule, so as to facilitate international comparability.

Some countries may consider that the existence of elements of a direct investment relationship may be indicated by a combination of factors such as:

- Representation on the board of directors;
- Participation in the policy-making processes;
- Material inter-company transactions;
- Interchange of managerial personnel;

Box 4

Other approaches to identifying FDI

- Provision of technical information; and
- Provision of long-term loans at lower than existing market rates.

Other relationships may exist between enterprises in different economies which exhibit the characteristics set out above, although there is no formal link with regard to shareholding. For example, two enterprises, each operating in different economies may have a common board and common policy-making and may share resources, including funds, but with neither having a shareholding in the other of 10 per cent or more. In such cases where neither is a direct investment enterprise of the other, the transactions could be treated as if between related subsidiaries. These are not regarded as direct investment.

Source: OECD (1996: 8).

Box 5

What is not FDI

- An enterprise undertakes a contract to build a complete manufacturing plant, to provide technical know-how, and to manage and operate a plant for a number of years for a foreign client, generally a Government, without an ongoing, on-site managerial presence and without other criteria for the existence of a direct investment enterprise being met It has complete control over day-to-day operations and receives a management fee, paid either in cash or in goods produced by the plant, however, the enterprise has no equity stake in the plant and is performing a cross-border service.

- An enterprise has a long-term contract with a foreign company, provides it with technical know-how, and has considerable influence over the quality and quantity of output. The enterprise may provide a loan to the foreign company and sometimes will have a member on the company's board, however, there is no equity stake. It is once again a cross-border service.

- Some host countries have made agreements with a number of foreign enterprises where the host country supplies factory accommodation, electricity, staff accommodation, administration and labor. The foreign enterprise supplies all production machinery, fixtures and fittings for the building and production materials, and is responsible for the initial training of the labor force. The foreign enterprise then pays an agreed piece-work rate for each item produced and the production machinery and fixtures and fittings remain the property of the foreign enterprise. There is technically a direct investment branch, though the branch's profits will be zero. There is no direct investment interest if the machinery becomes the property of the host country.

- Some professional firms operate much like a multinational firm, but do not hold equity in one another. For example, unaffiliated (in an equity sense) accounting or management consulting firms may operate globally under a single name. These firms may refer business to one another and receive fees in return, share costs (or facilities) for items such as training or advertising, and may have a board of directors to plan business strategy for the group. This is not direct investment, and would be difficult or impossible to account for as such, but it does have much in common with direct investment.

- Other cases might include foreign sales and representative offices, as well as foreign stations, ticket offices, and terminal or port facilities of domestic airlines or ship operators. Such offices or activities can be treated as direct investment only if they meet the requirements of residence and the attribution of production in an economy as defined in the IMF Balance of Payments Manual, fifth edition.

Source: OECD (1996: 9).

3 Transnational corporations and related concepts

As noted in the preceding section, FDI is undertaken mainly by TNCs, and the concepts of FDI and TNCs are closely interlinked. Broadly defined, a TNC is an enterprise that engages in FDI and owns or controls value-adding activities in more than one country (Dunning, 1993: 3). Definitions that elaborate further the characteristics considered necessary for a firm to be considered a TNC are given below (box 6).

Box 6

Definitions of transnational corporations and enterprises

The Draft United Nations Code of Conduct on Transnational Corporations (para. 1) has defined "transnational corporations" as "an enterprise, comprising entities in two or more countries, regardless of the legal form and fields of activities of these entities, which operates under a system of decision-making, permitting coherent policies and a common strategy through one or more decision-making centres, in which the entities are so linked, by ownership or otherwise, that one or more of them may be able to exercise a significant influence over the activities of others, and, in particular, to share knowledge, resources and responsibilities with the others."

The Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices adopted by the United Nations General Assembly on 5 December 1980 provides that the term "enterprises" means: "firms, partnerships, corporations, companies, other associations, natural or juridical persons, or any combination thereof, irrespective of the mode of creation or control or ownership, private or State, which are engaged in commercial activities, and includes their branches, subsidiaries, affiliates, or other entities directly or indirectly controlled by them."

The OECD Guidelines for Multinational Enterprises (para. 8) describe a multinational enterprise as: "These usually comprise companies or other entities whose ownership is private, State or mixed, established in different countries and so linked that one or more of them may be able to exercise a significant influence over the activities of others and, in particular, to share knowledge and resources with others. The degrees of autonomy of each entity in relation to the others varies widely from one multinational enterprise to another, depending on the nature of the links between such entities and the fields of activity concerned."

Source: UNCTAD (1999b: 45-46).

TNCs are thus incorporated or unincorporated enterprises comprising parent enterprises – based in their home countries – and their foreign affiliates – located in host countries (UNCTAD, 2008):

- **A parent enterprise** is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake.
- A **foreign affiliate** is an incorporated or unincorporated enterprise in which an investor, who is resident in another economy, owns a stake that permits a lasting interest in the management of that enterprise (an equity stake of 10 per cent for an incorporated enterprise or its equivalent for an unincorporated enterprise is the usual threshold).

Foreign affiliates include subsidiary enterprises, associated enterprises and branches, as defined below (see also box 7 and UNCTAD, 2005: 297):

- A **subsidiary** is an incorporated enterprise in the host country in which the parent entity directly owns more than half of the shareholders' voting power and has the right to appoint or remove a majority of the members of the administrative, management or supervisory body.
- An **associate** is an incorporated enterprise in the host country in which the parent entity owns a total of at least 10 per cent, but not more than half, of the shareholders' voting power.
- A **branch** is an unincorporated enterprise in the host country that is wholly or jointly owned by the parent entity.

Subsidiaries and associate enterprises are incorporated in the host country and are hence legal entities that are directly or indirectly owned or controlled by foreign nationals or companies. Branches are unincorporated enterprises and are not legal entities separate from their owners; the fixed and other assets used in branches do not belong to them but to the parent entities. Branches as such can neither engage in transactions with other economic units nor can they enter into contractual relationships with other units or incur liabilities on their own behalf.

Box 7

Subsidiaries, associate companies and branches

The OECD recommends the following definition of these enterprises:
Subsidiary companies
Company X is a subsidiary of enterprise N if, and only if:
(a) enterprise N either is a shareholder in or member of X and has the right to appoint or remove a majority of the members of X's administrative, management or supervisory body; or owns more than half of the shareholders' or members' voting power in X; or

Box 7

Subsidiaries, associate companies and branches

(b) company X is a subsidiary of any other company Y which is a subsidiary of N.

Associate companies

Company R is an associate of enterprise N if N, its subsidiaries and its other associated enterprises own not more than 50 per cent of the shareholders' or members' voting power in R and if N and its subsidiaries have a direct investment interest in R. Thus company R is an associate of N if N and its subsidiaries own between 10 and 50 per cent of the shareholders' voting power in R.

Branches

A direct investment branch is an unincorporated enterprise in the host country that:
(a) is a permanent establishment or office of a foreign direct investor; or
(b) is an unincorporated partnership or joint venture between a foreign direct investor and third parties.

Source: OECD (1996: 10).

The production of goods and services under the control or governance of TNCs constitutes what is called international production. For the world economy as a whole, international production comprises the production of parent firms (and their domestic affiliates) in their home countries and that of their foreign affiliates in host countries. International production in TNC home countries includes production by parent firms and their domestic affiliates in those countries, while international production in host countries includes production by foreign affiliates located in those countries. The concept of international production is generally confined to production by TNC systems (comprising parents and their domestic and foreign affiliates). A broader view of TNC systems would include also other firms linked with TNCs, such as suppliers and partners in various kinds of alliances and agreements related to their production activities.

The universe of TNCs is large, diverse and expanding. By the early 1990s, there were an estimated 37,000 TNCs in the world, with at least 170,000 foreign affiliates. Of these, 33,500 were parent corporations based in developed countries. By 2008 the number of TNCs had risen to some 82,000 with at least 810,000 foreign affiliates, almost half of which are now located in developing countries (UNCTAD, 2009: 21).[2]

[2] For regular updates, see the annual reports of UNCTAD's World Investment Report series at *http://www.unctad.org/wir.*

Because large TNCs account for a significant part of world FDI and international production – with some of them operating hundreds of plants around the world – attention is often focused on them. However, the number of small and medium-sized TNCs is growing and their role in international production activity has received recognition in recent years.

4 FDI and portfolio investment

As noted, the most important characteristic of FDI, is that it is undertaken with a view to control or exercise significant management interest over the enterprise in which the investment is made. In contrast, portfolio investment is not made with the objective of exerting a significant influence over the invested enterprise, but only with the expectation of a future return such as dividends or capital gain (box 8). Foreign direct investors are generally producers of goods and services, while foreign portfolio investors are often financial institutions, institutional investors or individuals. Nevertheless, the dividing line between the two is not always clear cut, and an arbitrary 10 per cent equity stake is used to distinguish between them for data collection purposes.

Traditionally, investment in companies has been categorized as either direct or portfolio investment. In the nineteenth century, because of the difficulties of controlling an enterprise from abroad, the dominant form of investment in foreign companies was portfolio investment, with the principal exceptions being in specific sectors (e.g., public utilities, natural resources). By the mid-twentieth century, however, with the liberalization of foreign investment regimes as well as further improvements in transportation and communication, the stock of FDI exceeded the total amount of foreign portfolio investment (UNCTAD, 1999b: 8).

This evolution may have also reflected a change of perception regarding FDI. The question of ownership and control by foreigners has become less problematic as awareness has grown of the role that FDI can play as an external resource, especially for countries with difficulties in obtaining access to other types of financing. Perceptions regarding the potential economic impact of the two kinds of flows and experience have also played a role. For instance, developing countries concerned about the vulnerability of their balance of payments to volatile capital flows have often been cautious about foreign portfolio investment which has sometimes been perceived as purely speculative, while favoring FDI, which has been perceived as a productive investment. As FDI by definition involves a lasting interest of the foreign investor, it is usually associated with long-term flows which are more stable when compared to portfolio investment, which is often short-term.

Box 8

Direct and portfolio investment – different interests of investors

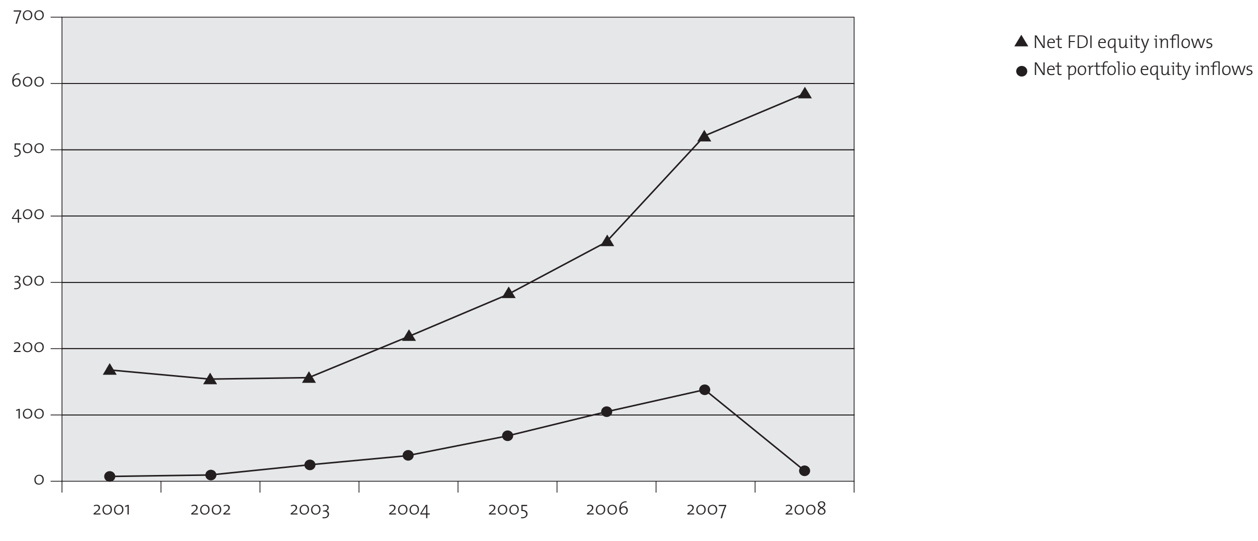
The benefits that direct investors expect to derive from a voice in management are different from those anticipated by portfolio investors having no significant influence over the operations of enterprises. From the viewpoint of direct investors, enterprises often represent units in a multinational operation, the overall profitability of which depends on the advantages to be gained by deploying the various resources available to the investors in units located in different economies. Direct investors are thereby in a position to derive benefits in addition to the investment income that may accrue on the capital that they invest (e.g., the opportunity to earn management fees or other sorts of income). Such extra benefits are likely to be derived from the investors' associations with the enterprises over considerable periods of time. In contrast, portfolio investors are primarily concerned about the safety of their capital, the likelihood of appreciation in value, and the return generated. Portfolio investors will evaluate, on a separate basis, the prospects of each independent unit in which they might invest and may often shift their capital with changes in these prospects, which may be affected by short-term developments in financial markets.

Source: IMF (1993: 86).

FDI flows to developing countries have been consistently larger than portfolio investment flows to those countries for all the last decade, and the gap has magnified in the last 3 years (figure 1). FDI now represents the largest source of external finance for developing countries (see theme 2 of this module).

Figure 1

FDI and portfolio flows to developing countries, 2001-2008 (percentage)



Source: World Bank (2005: 16).

It must be noted, however, that enterprises with active financial policies often engage in portfolio investment, not necessarily for financial speculation purposes but for risk management. Foreign portfolio investment can often be found as part of the investment activity of a TNC. Moreover, even though in most cases, portfolio investment is a short-term venture, and more sensitive to financial crises, exchange rate fluctuations and other changes versus FDI, portfolio investment can also be long-term in nature. This also helps to explain why many countries seek to attract both FDI and foreign portfolio investment.

5 Modes of FDI entry

As mentioned in the introduction, FDI may enter a host country in two different ways: through greenfield investment; or through a merger with or acquisition of an enterprise that already exists in the host country. M&As are the dominant mode of TNC entry in developed countries, and are growing in importance in developing countries as well. TNCs choose between the two modes of entry on the basis of their objectives, as well as industry characteristics and host-country characteristics and regulations. The choice of entry mode has implications for both TNCs and host countries.

Greenfield investment. A TNC can choose to undertake greenfield investment, that is to set up a new production venture in a host country. While the factors underlying the choice are specific to individual firms, the greenfield mode of entry is more likely when speed of entry and access to proprietary assets are not priorities for the investing firm, and when the possibilities for entry through M&As are limited due to lack of suitable target firms to acquire or regulatory obstacles. Greenfield FDI is the principal form of FDI entry into developing countries, in many of which enterprise development is limited. In this case, acquiring proprietary assets is rarely the motive for FDI, and M&As by foreign firms are often restricted (box 9). Developing countries may prefer greenfield investment to M&As because the latter, which by definition involves a transfer of assets from domestic to foreign investors, at least initially does not add to the productive capacity of host countries.

Mergers and acquisitions. The second possible mode of FDI entry is for an investing firm to merge with or acquire an existing local firm in the host country.

In a cross-border merger, the assets and operations of two firms belonging to two different countries are combined to establish a new legal entity.

In a cross-border acquisition, the control of assets and operations is transferred from a local to a foreign company, the former becoming an affiliate of the latter.

As noted, cross-border M&As are the principal mode of FDI entry into developed countries. Their importance in developing countries has also grown, partly because of privatization programmes open to foreign investors and special circumstances such as the Asian financial crisis of the late 1990s when distressed private firms in affected countries were made available for acquisition by foreign firms. The 1990s, in particular, saw a dramatic increase in cross-border M&As, which rose in value from US$150 billion in 1990 to a record US$1.1 trillion in 2000 (which represented 82 per cent of world FDI inflows). Although the wave of M&As slowed down after 2000, they continue to account for a significant part of global FDI flows (e.g. the US$880 million of M&As in 2006 accounted for 67 per cent of the US$1306 million FDI inflows in the same year.[3]) Cross-border M&As in general have been strongly affected as a direct consequence of the recent crisis, with a 35 per cent decline in their value in 2008 compared with 2007. A fall was also recorded for the first half of 2009. The decrease in total cross-border M&As has had a significant impact on FDI flows, as they are strongly correlated with the value of cross-border M&A transactions.

The choice between M&As and greenfield investment as a mode of entry depends on the motives and strategies of the firm as well as host-country conditions. From the foreign investor's end, the choice between M&A and greenfield modes of entry is driven by several factors. The most important reasons why firms prefer to expand internationally through M&As rather than greenfield ventures include the speed with which M&As enable the attainment of desired goals such as a certain production capacity, market size or level of profit, and the quest for strategic assets that host-country firms may possess. Other factors, which play out differently in different industries and markets, include the search for new markets and market power; anticipated efficiency gains through synergies, the quest for company expansion (particularly in operations requiring economies of scale), the desire for risk reduction through product or geographical market diversification, financial motivation, and even personal gains for corporate managers. On the host-country side, the main factors affecting the choice include the availability of suitable target firms for M&As and policy and institutional framework for M&As (box 9).

[3] For regular updates, see the annual reports of UNCTAD's World Investment Report series at *http://www.unctad.org/wir*. As shown in box 11 caution should be used as to not necessarily count M&As entirely as FDI flows.

Box 9

Host country factors that influence FDI entry modes

Level of economic development. While both modes may be options in developed countries with a large pool of strong private enterprises and well-functioning markets for corporate control, this is not always the case in developing countries and economies in transition. For example, M&As are typically not a realistic alternative to greenfield investment in the least developed countries, in which investment opportunities may exist but there are few firms to acquire. In other developing countries with a more advanced industrial sector and more developed capital markets, the acquisition of a local firm can represent a realistic alternative to greenfield FDI. Mergers between local firms in many developing countries and developed country firms are typically not feasible because of large differences in size, technology or management experience. In general, the higher the level of development of a host country, the larger the supply of firms that may be targeted for cross-border M&As.

FDI policy. Another obvious prerequisite for cross-border M&As is that they have to be permitted by the national regulatory framework. The liberalization of FDI regimes has gone far, and most countries now actively promote the inflow of FDI. In many cases, liberalization applies to both greenfield FDI and cross-border M&As. However, in a number of developing countries, foreign takeovers are de facto (if not de jure) restricted. Even in some developed countries, authorization is needed for the acquisition of companies in certain industries. Policy liberalization with regard to foreign acquisitions has been shown to have a strong impact on the pattern of inward FDI in countries with a strong industrial base. In Argentina, for example, cross-border M&As accounted for almost 60 per cent of total FDI inflows between 1992 and 1999. While privatization was initially responsible for the bulk of M&As, foreign acquisitions of private firms also gradually increased in importance.

Institutional framework. The balance between cross-border M&As and greenfield FDI is also related to the institutional environment. For example, even among developed economies, the use of M&As is affected by differences in corporate governance and ownership structure. These help to explain the diverging patterns of M&As in the United States (US) and the United Kingdom (UK), on the one hand, and Germany and Japan on the other. In developing countries, underdeveloped asset markets and poor accounting standards may make it more difficult to assess accurately the value of corporate assets.

Exceptional circumstances. Examples include financial crises (as in East Asia in 1997-1999) and large privatization programmes (as in Latin America and Central and Eastern Europe). Both produced, though for different reasons, a large one-off supply of firms in financial or competitive trouble. In both sets of circumstances, policy makers have welcomed the cross-border acquisitions of local enterprises: greenfield FDI could not in these circumstances play the role of cross-border M&As in rescuing ailing companies and restructuring State-owned firms.

Source: UNCTAD (2000: 160-161).

6 Measurement of FDI and TNC activity

The measurement of FDI and related economic activities is useful for monitoring trends and patterns in FDI at the country, regional and global levels and for analyzing the impact of FDI and international production on home and host economies. This provides a basis for informed policy decisions about FDI and for international negotiations on FDI. Overall, data gathering on FDI is much less developed than that on international trade and systematic data at the industry level is lacking for most countries, however data on a few indicators is available for select countries.

The most common indicators are FDI flows and stocks. Data on these indicators is gathered on the basis of an ownership criterion for identifying FDI, generally based on the IMF and the OECD definitions (section 2) and excludes non-equity forms of FDI. Though they have various limitations, flow and stock data is available for many countries and thus allows inter-country comparisons and provides a basis for obtaining regional and global totals.

Other measures relate to the activities or operations of parent firms and foreign affiliates, e.g. investment expenditures, sales, assets, employment, output, exports, etc., on which data is collected in some countries. Data on the numbers of TNC parent companies and foreign affiliates is collected by UNCTAD from individual countries. UNCTAD also collects data on the assets, sales, employment figures and number of affiliates of the hundred largest TNCs world-wide as well as the 50 largest TNCs in developing countries.

6.1 FDI flows and stocks

FDI flows are measured as the value of all capital transactions between direct investors (parent enterprises) and their foreign affiliates during a given period. Data is collected by each country separately on its FDI outflows (capital is provided to foreign affiliates either directly or through other related enterprises by investors based in the country) and FDI inflows (capital is received by foreign affiliates from their parent firms, either directly or indirectly through other related enterprises). This is done on an annual basis. The data is reported in the country's balance-of-payments accounts as "direct investment credits" (which refers to inflows) and "direct investment debits" (which refers to outflows).

FDI flows measured as described above include three components: equity capital, reinvested earnings, and intra-company loans (box 10; UNCTAD, 2005: 297-298).

- **Equity capital** is the direct investor's purchase of shares of an enterprise in a country other than that of its residence.
- **Reinvested earnings** comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by its foreign affiliates, or earnings not remitted to the direct investor. Such retained profits are considered reinvested.
- **Intra-company loans** or intra-company debt transactions refer to short- or long-term borrowing and lending of funds between direct investors and their foreign affiliates.

Data on FDI flows are reported on a net basis for each FDI project (capital transactions' credits less debits between direct investors and their foreign affiliates) in countries' balance of payments accounts. Net decreases in assets (outward FDI) or net increases in liabilities (inward FDI) are recorded as credits (these are recorded with a positive sign in the balance of payments). Net increases in assets or net decreases in liabilities are recorded as debits (these are recorded with a negative sign in the balance of payments). In common or analytical usage, the negative signs are reversed for practical purposes in the case of FDI outflows; hence, data on FDI flows with negative signs usually indicate that at least one of the three components of FDI is negative and is not offset by positive amounts of the other components. These are instances of reverse investment or disinvestments by direct investors of the country concerned (e.g. outward FDI flows and disinvestments by direct investors of other countries combined and inward FDI flows).

Box 10

IMF definitions of FDI components

Equity capital covers equity in branches, shares (whether voting or non-voting) in subsidiaries and associates, and other capital contributions (such as the provision of machinery by a direct investor to a direct investment enterprise) that constitute part of the capital of the direct investment enterprise. Equity capital also covers the acquisition by a direct investment enterprise of shares in its direct investor. However, nonparticipating preference shares are not part of equity capital but are treated as debt securities and classified as other direct investment capital. Purchases and sales of land and buildings by nonresidents are also included in the equity capital component.

Reinvested earnings are the direct investors' shares (in proportion to equity held) of the undistributed earnings of the direct investment enterprises. Reinvested earnings are considered to be additional capital of the direct investment enterprises. They are recorded as direct investment income, with an offsetting capital transaction.

Other capital (or inter-company debt transactions) covers the borrowing and lending of funds, including debt securities and trade credits, between direct investors and direct investment enterprises, and between two direct investment enterprises resident in different countries that share the same direct investor. Debt claims on the direct investor by the direct investment enterprise are also included as direct investment other capital. As indicated above, nonparticipating preference shares are treated as debt securities and are therefore classified as other capital.

Source: IMF and OECD (2003: 35).

Data on FDI flows of countries has a number of shortcomings. The data is collected primarily by the central banks for balance-of-payments purposes and often excludes reinvested earnings, which can be an important component of FDI flows. In some countries, boards of investment or investment promotion agencies are the main sources of data on FDI flows, and the data they provide is often on FDI approvals rather than values of implemented projects. This data also tends to be incomplete, as these agencies typically deal only with manufacturing FDI. Annex 1 provides guidelines provided by the OECD on the compilation of FDI data and annex 2 provides information on sources and methods of FDI data collection.

In addition to data on FDI inflows and outflows, the balance-of-payments statements of countries also reports information on flows of direct investment income from foreign affiliates to parent firms. Thus for each country, data is reported on inflows of direct investment income from foreign affiliates of parent firms based in the country and outflows of such income from foreign affiliates, located in the country, to their parent firms abroad.

While FDI flows are measures of annual inflows and outflows of FDI, FDI stock is the accumulated value of assets due to those flows. It is measured as the share of a parent enterprise in its foreign affiliates' capital and reserves (including retained profits), plus the net indebtedness of the foreign affiliates to the parent enterprise. A country's outward FDI stock is the sum of the FDI stocks of parent enterprises based in the country, and its inward FDI stock is the sum of FDI stocks held in foreign affiliates located in the country by their parent enterprises abroad.

FDI stocks show the direct investment positions of countries at a given point in time. As long as FDI flows are positive, even if they decline from year to year, they increase countries' FDI stocks. FDI stocks provide a better long-term picture of a country's FDI performance than flows, which can fluctuate from year to year.

Data on outward and inward FDI stock is collected in some countries through periodic surveys of direct investment enterprises (parent companies and their foreign affiliates and foreign affiliates in the country) that also collect other financial and operational data. The stock values obtained from these surveys generally reflect the book value of assets (on a historical basis) rather than market value which is considered preferable (e.g. by the OECD, see annex 1) as the basis for stock valuation when comparing assets of different vintages. Between periodic surveys, and in the case of countries that do not conduct such census or benchmark surveys, stock data can be estimated by adding annual FDI flows; this is done, for example, to calculate the FDI stock figures in UNCTAD's World Investment Reports.

Data on FDI flows and stocks is widely used to monitor trends in countries' FDI and to make inter-country comparisons, both of the flows and stocks themselves and of their importance relative to other national aggregates such as gross fixed capital formation and GDP. They are used as indicators not only of capital or resource flows (annual and accumulated) due to TNC activity, but also as rough indicators of the international production activity of TNCs. It must be recognized, however, that FDI flows are not an investment in the national-income in an accounting sense (expenditure on new capital goods or fixed assets), but as capital flows in the balance-of payments-sense (credits and debits on an international capital account). Thus, although the concept of FDI relates to the cross-border expansion of production (and hence, investment in fixed capital or production facilities) by TNCs, changes in FDI flows and stocks may, or may not, be accompanied by closely corresponding changes in production capacity and production activity by TNCs (annex 3). This could happen, moreover, not only because all of the financial flow recorded as FDI may not go into fixed investment in foreign affiliates, but also because TNCs can draw on other resources (such as borrowing in host-country or international markets) in addition to their FDI flows in order to finance capital formation in foreign affiliates.

Box 11

FDI flow data versus M&A data

Mergers and acquisitions have a large share in FDI flows, but M&A transactions are not necessarily counted entirely as FDI, even if undertaken by a foreign investor. Indeed there are other sources of finance for foreign investors not captured by FDI flows. A simple case could be that the foreign investor is using local or international capital markets to finance parts of the acquisition, thus reducing the financial transfer from his home country that is counted as FDI. Furthermore, the payment might be phased over several years such that the year of acquisition is not the year the FDI flow is registered.

A practical example is reported from Brazil. In July 1998, Brazil privatized Telebrás System, the State-owned Brazilian group comprised of some 20 Brazilian telecommunications companies. The State sold its interests in Telebrás System for US$18.9 billion. Foreign investors invested US$12.62 billion (or about two-thirds of the total sale). The payments were supposed to be phased over three years, with 40 per cent in 1998, 30 per cent in 1999 and 30 per cent in 2000.

Box 11

FDI flow data versus M&A data

The payments from 1998 were made in 1998; the payments for 2000 were advanced in 1999 and made together with the 1999 payments. Out of the total of US$12.62 billion, US$5.26 billion were paid in 1998, of which US$2.72 billion were borrowed in international capital markets.

If the total amount paid by foreign investors for the privatization of Telebrás (US$12.62 billion) would have been calculated as a per cent of total 1998 FDI inflows (or US$26 billion), the ratio would have been 48 per cent. In reality, however, only about 10 per cent consisted of FDI inflows on account of Telebrás privatization in 1998.

Caution is therefore needed when calculating M&A as a percentage of FDI. It should be kept in mind that the concepts are different and therefore M&A is not always simply a part of FDI.

Source: UNCTAD (1999a: 8).

6.2 Other measures of TNC activity

Measures of various operational aspects of international production activity by TNCs can provide a fuller and clearer picture of the role and impact of FDI in home and host countries. Statistical offices in a limited number of countries collect data on sales, gross product, assets, exports and/or employment of foreign affiliates of parent firms based in the countries, and of the TNC parent firms themselves, on the basis of company surveys. This data is particularly useful when they are disaggregated by industry, and is widely used in research and analysis on FDI and TNCs. It is also used to prepare indicators such as UNCTAD's transnationality index of host economies, which is a measure comprising the average of four shares: FDI inflows as a percentage of gross fixed capital formation; FDI inward stock as a percentage of GDP; value added of foreign affiliates as a percentage of GDP; and employment of foreign affiliates as a percentage of total employment (UNCTAD 2005: 16).

7 Financial crisis and FDI

Turmoil in the financial markets and the worldwide economic downturn significantly affected global FDI flows in 2008 and in the first half of 2009. After uninterrupted growth in FDI activity from the period of 2003–2007, in fact, global FDI inflows fell by 14 per cent in 2008 to US$1,697 billion, from a record high of US$1,979 billion in 2007. While the 2008 level was the second highest in history, FDI flows began gradually declining over the course of that year. In the first half of 2009, FDI flows fell at an accelerated rate.

The pattern of FDI flows has varied by groups of economies. FDI inflows and outflows of developed countries plunged in 2008, with inflows declining by 29 per cent, to US$962 billion, and outflows by 17 per cent, to US$1,507 billion. FDI flows fell further as the financial crisis entered a tumultuous new phase in September 2008 following the collapse of Lehman Brothers, and as major developed economies fell into, or approached, recession. In the first half of 2009, developed countries' FDI inflows are estimated to have dropped by another 30-50 per cent compared with the second half of 2008.

In contrast, developing and transition economies saw FDI inflows rise in 2008 to record levels for both, with their shares in global FDI inflows growing to 37 per cent and 7 per cent respectively, from 27 per cent and 5 per cent in the previous year. The combined share was 43 per cent, close to the record share attained in 1982 and 2004, which demonstrates the increasing importance of these economies as hosts for FDI during the crisis – at least in 2008.

The inflows, however, started to decline in late 2008 as the economic downturn in major export markets began to seriously affect their economies, and as the risk premiums of their sovereign and corporate debt sharply increased. Thus the downturn in FDI inflows into developing and transition economies began almost one year after it had started in developed countries. This reflects the time lag associated with the initial economic downturn and consequent slump in demand in developed-country markets, which are important destinations for goods produced by developing-country and transition-economy firms.

There were declines in all three components of FDI inflows – equity, reinvested earnings and other capital flows – in late 2008 and early 2009, particularly in developed countries. Equity investments fell as cross-border M&As declined. Lower profits of foreign affiliates have been driving down reinvested earnings significantly, particularly in 2009. The restructuring of parent companies and their headquarters led, in some cases, to repayments of outstanding loans by foreign affiliates. As a result, net intra-company capital flows from TNCs to their foreign affiliates declined, or turned negative, which depressed FDI flows.

The structure of the fall in FDI flows in the current downturn is similar to that of the previous downturn in 2001. However, the proportionate decline in equity investments today *vis-à-vis* reinvested earnings and other capital flows is larger than that registered during the previous downturn. This development is striking, since the larger the proportion of the decline in FDI flows due to a fall in equity investment (as opposed to reinvested earnings and other capital flows), the longer the recovery is likely to take. This is because equity investments are relatively long term and are undertaken for the purpose of funding and expanding production facilities. They therefore require careful consideration by parent firms. Reinvested earnings and intra-company credit flows, on the other hand, are often determined by the short-term liquidity or tax-driven motivations of TNCs, and can recover rapidly, even in response to temporary government measures (e.g. tax incentives).

FDI flows to developing countries, however, have proved to be more resilient in 2008 and 2009 than other capital flows, such as portfolio investments and bank lending. The main reasons for this are that FDI is more of a long-term nature than other capital flows.

The positive and even relatively high economic growth rates that still prevail in several developing countries (e.g. China, India) are also a countervailing force against low export demand and low commodity prices, which exert a downward pressure on FDI. FDI inflows into developing countries are projected to fall in 2009, but should nevertheless remain relatively high overall, with expected net inflows of about US$400 billion (IMF, 2008). In contrast, net flows of both portfolio investment and bank loans to developing countries are expected to turn negative.

Not all companies were similarly affected by the crisis. The fairly long upward trend of the world economy over the past four years or more strengthened the financial and competitive position of many TNCs. The financial crisis and the fall in stock markets also give them the opportunity to tap new markets or to acquire former competitors. In fact, the need for consolidation of the most affected financial institutions, as well as enterprises in other sectors, has encouraged FDI transactions.

8 Conclusion

Firms and individuals may invest and hold assets in their home countries and/or in other countries. One way in which they may invest abroad is through FDI, which involves control or effective voice in the management of and lasting interest in the invested enterprise by the foreign investor. FDI is undertaken mainly by TNCs, which establish foreign affiliates through investment in new production facilities or M&As with existing firms in host countries. It is commonly defined in terms of a minimum threshold of equity ownership by the parent TNC in its foreign affiliate but it may also take the form of non-equity investment or contractual agreements that provide firms with control over foreign firms with which they have such agreements. Driven by liberalization and increased transnationalization of companies worldwide, FDI flows have increased rapidly in the past decades and not only now exceed foreign portfolio flows, but also represent the largest source of external financing for developing countries.

The extent and pattern of FDI and TNC activity are measured through several indicators. The most common are FDI flows and stocks on which data is available for a large number of countries, although with several shortcomings. Other measures include those related to various aspects of TNC activity and international production, such as foreign affiliates' assets, output, employment and exports. Data on this magnitude available for a limited number of countries is useful for obtaining a fuller picture of international production by TNCs and the impact of FDI on various aspects of host and home countries.

Exercises and questions for discussion

1. What are the main differences between the definitions of investment from the macroeconomic, financial and legal points of view? Give examples of investment that fall under each definition.
2. List and discuss the main characteristics that define FDI.
3. How can a lasting interest be identified? In your opinion, what other type of interest can an investor have in an enterprise?
4. Give examples of possible reasons for not applying the 10 per cent threshold of foreign equity ownership in identifying FDI.

Exercises and questions for discussion

5. Give examples of TNCs you know, preferably from your country. Discuss them in groups to identify their common features.
6. In your opinion, are all TNCs large companies in terms of assets or sales? Justify your answer.
7. Define a TNC. Define parent enterprises and foreign affiliates.
8. Define the main types of foreign affiliates. What is the difference between them? What is portfolio investment? Give examples.
9. Does only short-term investment classify as portfolio investment? Justify your answer.
10. Discuss in two groups possible reasons why, in your opinion, a country may prefer one form of foreign investment to the other.
11. In a host economy that allows both FDI and portfolio investment, what ways can you explain the fact that FDI flows are larger than portfolio flows? Discuss them in groups.
12. Discuss in two groups the possible reasons for which an investor might prefer a merger to an acquisition and vice versa.
13. Name two reasons that would make M&As more popular as modes of FDI entry in developed countries than in developing countries.
14. What are the main components of FDI flows? How are they measured?
15. What is the difference between inward and outward FDI?
16. What is the difference between stocks and flows of FDI?
17. What is the main relevance of FDI flows compared to FDI stocks for the purpose of economic analyses related to FDI?

18. **Practical exercises**

A TNC specialized in textile manufacturing wants to invest in your country. It seeks to increase its production capacity through opening a plant there and it intends to export a part of the products produced in this plant to developed country markets with the rest to be sold on the host country market.

Find possible arguments in favour (group 1) and possible arguments against (group 2) the choice of a greenfield investment instead of a merger or acquisition from the point of view of the host country. Find the same from the point of view of a TNC (group 3 for greenfield versus group 4 for merger or acquisition).

In the end, discuss your arguments as follows: group 1 with group 4 and group 2 with group 3. The purpose is for each group to convince the other that investment according to its preferred entry mode is the preferable option.

Privatization-related foreign investment in Bolivia's telecommunication (UNCTAD, 2005: 169)

Bolivia privatized its long distance telecommunication company ENTEL through international public bidding, open to national and foreign investors. ETI Euro Telecom International (an affiliate of Telecom Italia) made the winning bid. Through the capitalization of ENTEL, it agreed to inject fresh capital equal to US$610 million in the exchange for a 50 per cent share of equity participation (of the newly enlarged capitalized company) and 100 per cent management control. These resources were deposited in accounts of ENTEL to be used later investment plans and the fulfilment of technical (quality) requirements. This arrangement stipulated that the privatized enterprise could not invest abroad until it had met its commitments to expand services in rural areas and in public telephone services. Priority had been given to:

- The installation of telephone services in every community over 350 inhabitants;
- The installation of local services in every community over 10,000 in habitants;
- The replacement of manual and similar telephone exchanges with digital ones;
- A five-fold increase in the number of public telephone booths.

Questions:

- Does the investment made by ETI qualify as FDI? Justify your answer.
- After the privatization, did ENTEL become a foreign affiliate? If yes, what type?
- What was the entry mode chosen by ETI? Would the alternative have been a better solution from the investors' point of view? Discuss in groups and give arguments.
- What was the host country's influence on the privatization outcome?
- What are the benefits of this acquisition for ETI?

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THEME 2
International production: long-term trends and current patterns

INTRODUCTION

Since the mid-1980s international production has grown very rapidly – playing a larger and more important role in the world economy and changing the way in which economic integration takes place among countries. It has become a key driving force of globalization, growing faster than other economic aggregates such as national production and international trade. The nature of international production has also changed, responding to rapid technological change, intensified competition and economic liberalization. These factors, combined with falling transportation and communication costs, are allowing TNCs to integrate production processes and other corporate functions across countries in historically unprecedented ways. World Investment Reports have termed this process "deep integration" – integration at the production level – with specialized activities located by TNCs in different countries linked by tight, long-lasting bonds, in distinction from "shallow integration" of markets alone, brought about by arm's length trade that earlier dominated international economic relations (UNCTAD, 1999: 12).

After explaining what is the meaning behind the term international production, this chapter examines long-term trends in international production – its growth and relative importance in the world economy and in individual countries, its main types and forms and changes in its geographical and sectoral composition, paying particular attention to developing countries.

At the end of this theme, students should be able to:

- Understand what international production is and what its key forms are;
- Understand the increasing role of international production in the global economy;
- Describe long-term trends and changes in the forms of international production and the sectoral and geographical composition of FDI;
- Grasp the changing positions of developing countries in the world's inward and outward FDI arena;
- Characterize key features of FDI in developing countries: the forms of FDI, its sectoral composition, the changing relative positions of developing country regions in inward FDI and the emergence of TNCs from developing countries; and
- Analyze the role of and trends in FDI in their own countries.

HANDBOOK

1 What is international production?

International production refers to the production of goods and services in countries under the governance of firms – called TNCs. TNCs govern, i.e. they manage or exercise control, over production in countries (host countries) other than their own country (home country) either through the ownership of a minimum share in the equity capital stock or assets of the enterprises (foreign affiliates/FDI) in which the production takes place, or through contractual (non-equity) arrangements that confer control upon them (UNCTAD, 1999: 3; refer to Module 1, theme 1). As a result, international production systems emerge, in which not only goods and services but also factors of production move among units governed by TNCs, located in different countries. These systems increasingly cover a variety of activities, ranging from extraction of natural resources, to manufacturing, to service functions such as accounting, advertising, marketing, call centres, software development and financial services, research and development (R&D) and training – dispersed all over the host country and increasingly integrated between locations (host and home) to produce final or intermediate goods or services.

From the perspective of the world economy, all of the production that takes place in these systems (in parent firms or home-country units as well as in foreign affiliates or host-country units) constitutes international production. Viewed from the perspective of home and host countries, however, it is respectively the production by a domestic firm in a foreign location, and the production of a foreign firm in the domestic country that is foreign to them that constitutes international production.

It is this latter concept of production in foreign locations, or production by foreign affiliates, that is most commonly used to depict international production. For lack of better measures, flows and stocks of FDI are used as proxies for the activities of TNCs and international production. As explained in theme 1, FDI stocks give an idea about the accumulated value of the capital owned by TNCs that forms the basis for international production, while FDI flows represent annual changes in these stocks. Though imperfect measures, FDI data, especially flow data, is published by most countries of the world, thus permitting broad inter-country comparisons. This is not the case with other data, e.g., sales, output or employment, not counting production controlled through non-equity arrangements. This data is only available for selected countries and will also be used here to illustrate broad trends.

2 The increasing importance of international production

Until recently the principal form of countries' integration with the world economy was trade. International production as an important form of international economic involvement is a fairly recent phenomenon. A prominent scholar of international production and TNCs' activities, describing the post World War II situation, noted that production

> "undertaken by enterprises which deliberately coordinate their operations (purchasing, production, finance, R&D and marketing) on a global basis to make the most efficient use of their resources (material, financial, technical and managerial) is still more the exception than the rule. Even on the eve of World War II, the value of such production was only one-third that of international trade. In the mid-1950s and 1960s the growth of such production outpaced that of trade, and in spite of trade liberalization and rising oil prices, by 1976 it had exceeded that of trade" (Dunning, 1981: 388).

Table 1

Selected indicators of international production and worldwide FDI, 1982-2008

	Value at current prices (billions of dollars)				Annual growth rate (per cent)							
Item	**1982**	**1990**	**2007**	**2008**	**1986-1990**	**1991-1995**	**1996-2000**	**2004**	**2005**	**2006**	**2007**	**2008**
A. World FDI												
Inflows	58	207	1979	1697	23..6	22.1	39.4	30.0	32.4	50.1	35.4	-14.2
Outflows	27	239	2147	1858	25.9	16.5	35.6	65.0	-5.4	58.9	53.7	-13.5
Inward stock	790	1942	15660	14909	15.1	8.6	16.0	17.7	4.6	23.4	26.2	-4.8
Outward stock	579	1786	16227	16206	18.1	10.6	16.9	16.8	5.1	22.2	25.3	-0.1
Cross-border M&As	..	112	1031	673	32.0	15.7	62.9	28.4	91.1	38.1	62.1	-34.7
B. Foreign affiliates in host countries												
Sales	2530	6026	31764	30311	19.7	8.8	8.1	26.8	5.4	18.9	23.6	-4.6
Gross product	623	1477	6295	6020	17.4	6.8	6.9	13.4	12.9	21.6	20.1	-4.4
Total assets	2036	5938	73457	69771	18.1	13.7	18.9	4.8	20.5	23.9	20.8	-5.0
Exports	635	1498	5775	6664	22.2	8.6	3.6	21.3	13.8	15.0	16.3	15.4
Employment (millions)	20	24	80	77	5.5	5.5	9.7	12.2	8.5	11.4	25.4	-3.7
C. Economic aggregates												
GDP in current prices	11963	22121	55114	60780	9.5	5.9	1.3	12.6	8.4	8.2	12.5	10.3
Gross fixed capital formation	2795	5099	12399	13824	10.0	5.4	1.1	15.4	11.8	10.9	13.8	11.5
Royalties and licence fee receipts	9	29	163	177	21.1	14.6	8.1	23.7	10.6	9.1	16.1	8.6
Exports of goods and non-factor services	2395	4414	17321	19990	11.6	7.9	3.7	21.3	13.8	15.0	16.3	15.4

Source: UNCTAD (2009: 18).

In the past two decades all indicators of international production associated with TNC-governance through ownership have increased more quickly than national economic aggregates (table 1 and figure 2). As a result, international production is of considerable importance to the world economy, much greater than ever before. Global sales of foreign affiliates were nearly two times higher than global exports at the beginning of the 21st century, this is compared to near parity between them just two decades earlier. Global gross product attributed to foreign affiliates was about one tenth of global GDP in 2008, compared to around 5 per cent in 1982. The ratio of the stock of FDI to global GDP has risen from 5 per cent to approximately one fourth over this period. The ratio of FDI flows to world gross domestic capital formation was over 12 per cent in 2008, compared to 2 per cent in 1980 and 4 per cent in 1990.[4] It is significantly higher for manufacturing – around one fifth. It is typically much higher in developing than in developed countries. Furthermore, as TNCs dominate world industrial R&D (UNCTAD, 2004), FDI plays an important role in international technology transfer: in fact many state-of-the-art technologies cannot be obtained internationally, if at all, by means other than FDI. It is estimated that four fifths of technology flows are internalized within TNCs (UNCTAD, 1999: 154). TNCs account for estimated two thirds of world exports, out of which one-third is accounted for by TNC parents' export from home countries and another one-third by foreign affiliates' exports from host countries. Altogether, one third of the total world trade is intra-firm trade of TNCs (UNCTAD, 1999:154, 232-234). All in all, while the role of TNCs has increased in all aspects of the global economy, it is much larger in world trade and technology than in world production, investment and employment.

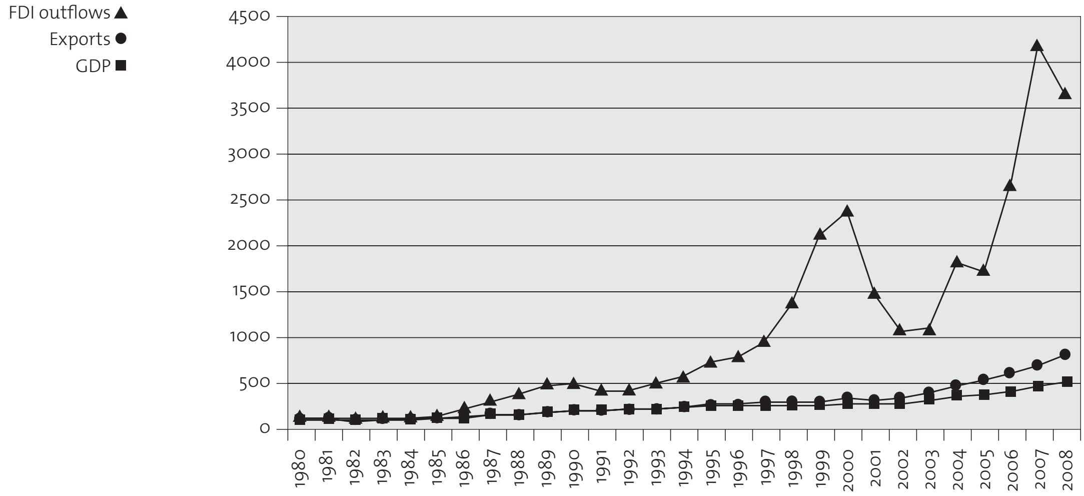
[4] The most recent data is taken from UNCTAD (2009: 18). Historical data is taken from the publications by the United Nation Centre on Transnational Corporations as well as from past UNCTAD World Investment Reports.

Figure 2

The growth of international production

Since the mid-1980s international production has grown very quickly ...

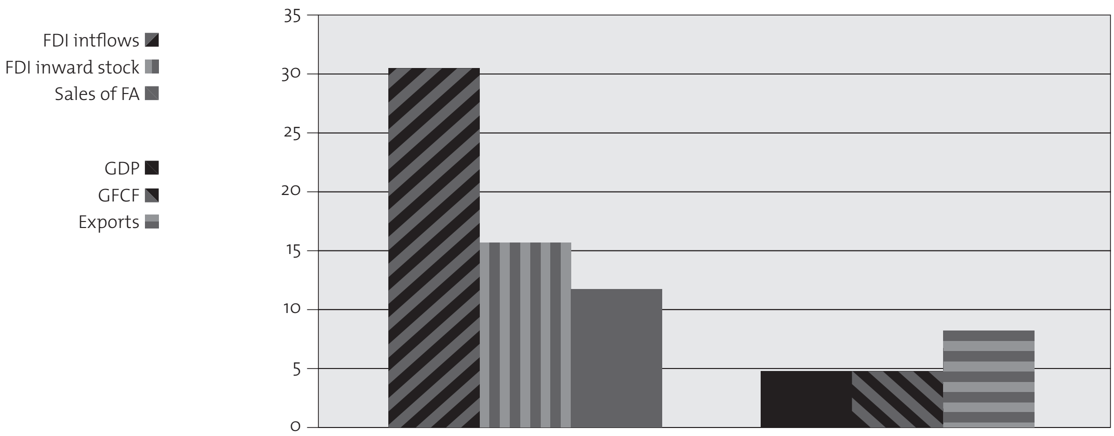
2a |



Source: UNCTAD GlobStat database, April 2009; IMF, World Economic Outlook database, April 2009.

... faster than world production, investment and exports ...

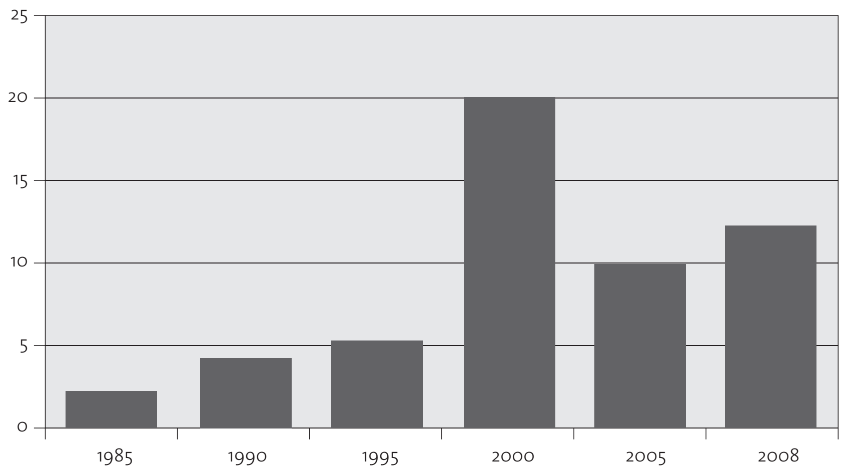
2b | Growth of FDI and economic aggregation in the world economy, 2008 (increase over 1985)



Source: UNCTAD, FDI/TNC database.
Note: FA foreign affiliates; GFCF gross fixed capital formation; exports refer to exports of goods and non-factor services.

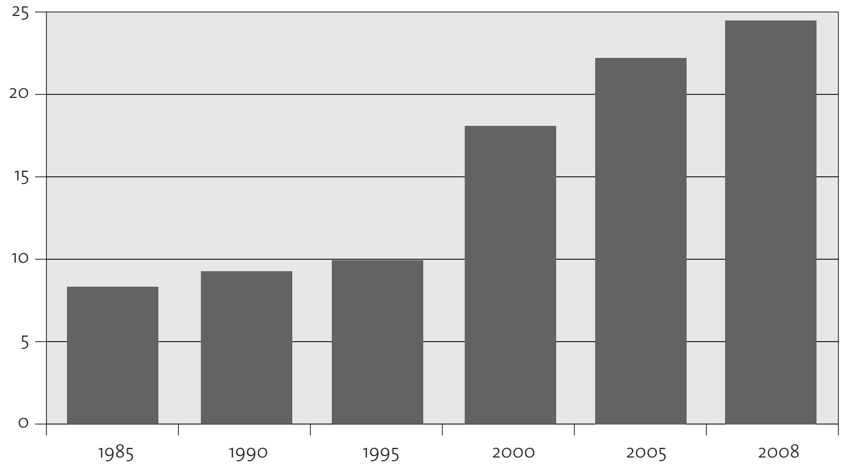
... and its relative importance in the world economy has significantly increased.

2c | The ratio of FDI inflows to GFCF, 1985-2008 (per cent)



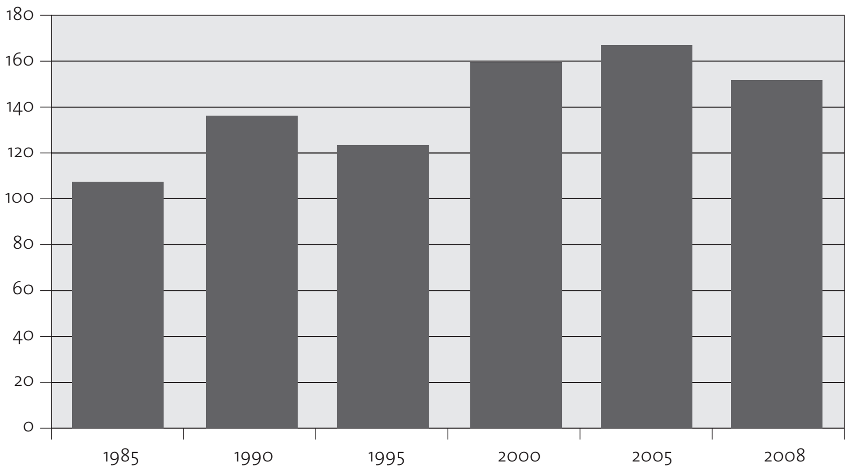
Source: UNCTAD, FDI/TNC database.

2d | The ratio of FDI inward stock to GDP, 1985-2008 (per cent)



Source: UNCTAD, FDI/TNC database.

2e | The ratio of sales of foreign affiliates to world exports (per cent)



Source: UNCTAD, FDI/TNC database.

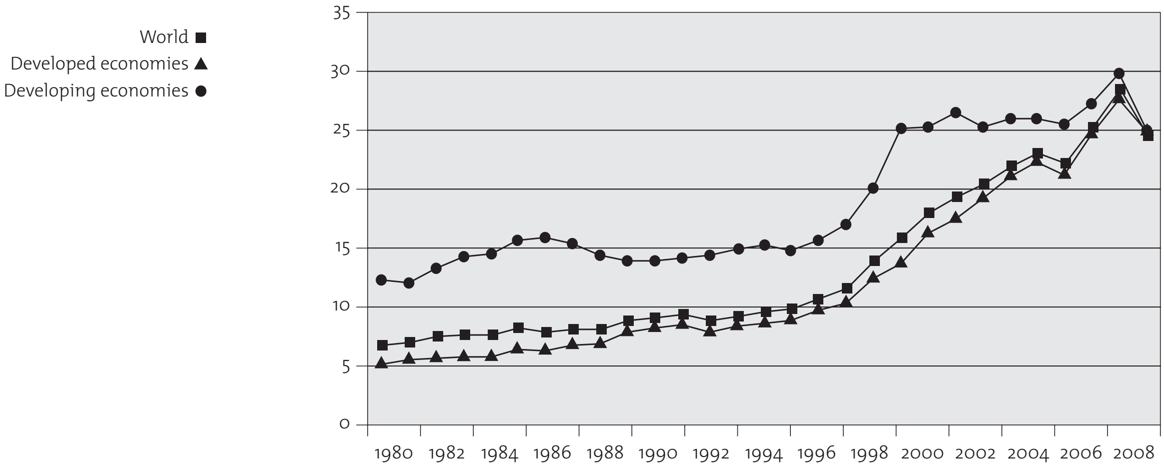
The number of firms that have become transnational has risen exponentially over the past three decades. In the case of 15 developed countries for which data is available, that number increased from some 7,000 at the end of the 1960s to 40,000 in the second half of the 1990s. The total number of parent firms worldwide is now around 82,000 with an estimated 810,000 foreign affiliates (UNCTAD, 2009: 17). They form a diverse universe that spans many countries and industries, and include a large and growing number of small and medium-sized enterprises (SMEs). In recent years, TNCs from developing countries and countries with economies in transition have become increasingly important in international production. Although the most visible TNCs are the largest ones (see UNCTAD, 2007: 24-28, for the profile of the largest TNCs in the world and from developing countries) most TNCs are small and medium-sized enterprises.

As mentioned earlier, in the absence of systematic data on the international component of world and national production (the world data shown in table 1 and figure 2 are estimates), stocks and flows of FDI are typically used as proxies, reflecting long-term trends and current patterns in the activities of TNCs and international production. They are available for many or most countries on an annual basis, over long periods. Both FDI stocks and flows have grown very rapidly and their importance in the world economy has increased, as measured by the ratios of FDI stock to GDP and FDI flows to GFCF. The FDI/GDP ratio has consistently increased between 1980 and 2008. It has also been higher in developing than in developed countries (figure 3), even though most of world inward FDI stock is located in developed countries – 70 per cent versus 30 per cent in developing countries in 2006 (UNCTAD, 2007: 255). This results from economies of developing countries, measured by their GDP, being much smaller than those of developed countries.

While growing fast in the long term, annual FDI flows of countries are, like other macroeconomic phenomena, cyclical in their behaviour. They tend to decline or slow down during periods of economic recession. World FDI flows typically fall in value during world economic recessions or slowdowns, as was the case during the recessions of the early 1980s and 1990s and the slowdown of the early 21st century (figure 4). It can take a couple of years (as in the case of the 1990s recession) or even several before the flows recover to a pre-recession peak. With regard to FDI stock, which represents the capacity for international production, while it does not decline during recession, it grows more slowly than in the pre- and post-recession periods. This results due to the fact that as long as FDI flows are positive (even if lower than in previous years) they add to FDI stock.

Figure 3

The ratio of FDI stock to GDP: world, developed and developing countries, 1980-2008 (percentage)



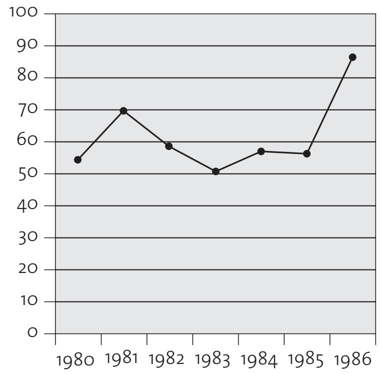
Source: UNCTAD, FDI/TNC database.

Figure 4

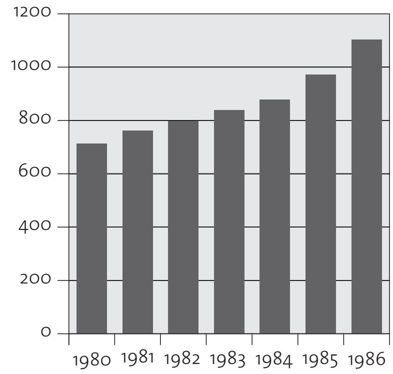
FDI during economic recessions and slowdowns (billions of US dollars)

Early 1980s

4a | World FDI inflows, 1980-1986

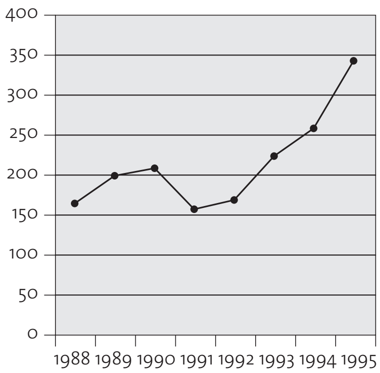


4b | World inward FDI stock, 1980-1986

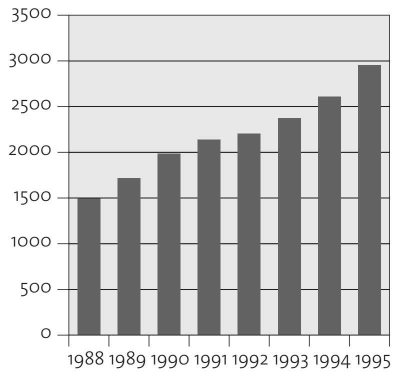


Early 1990s

4c | World FDI inflows, 1988-1995

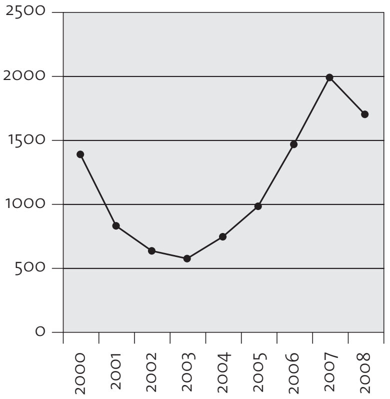


4d | World inward FDI stock, 1988-1995

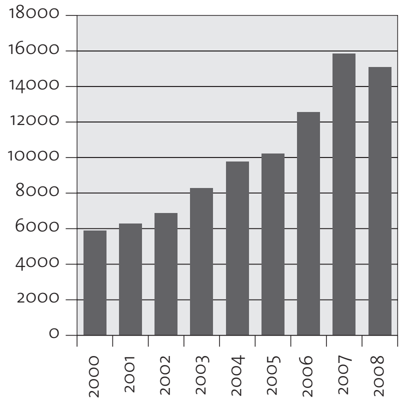


Early 21st century

4e | World FDI inflows, 2000-2008



4f | World inward FDI stock, 2000-2008



Source: UNCTAD, FDI/TNC database.
Note: The scale of values is different for each period.

3 M&As increasingly drive FDI

Cross-border M&As are now key drivers of FDI. During the second half of the 1990s, when FDI was booming, most of its growth was via cross-border M&As[5] rather than greenfield investment. It is not possible to determine precisely the share of cross-border M&As in FDI flows.[6] Making an extreme assumption that all cross-border M&As are financed by FDI (certainly incorrect for developed countries, but less so for developing countries and economies in transition),[7] the ratio of cross-border M&As to world FDI inflows increased from 52 per cent in 1987 to 83 per cent in 1999. For developed countries the ratio is much higher, having risen from 62 per cent to 100 per cent between the two years. For developing countries the ratio is lower, but is increasing with considerable variations among regions and countries (figure 5).

The bulk of cross-border M&As takes place between developed countries. In the decades after World War II, cross-border M&As were dominated by United States TNCs, whose acquisitions focused on Western European firms in response to the establishment of the European Union (EU, called at that time the European Economic Community, EEC). Gradually, firms from other developed countries entered the picture. In particular, EU firms started playing an increasingly important role: the share of the EU in cross-border M&A sales among developed countries increased from 34 per cent during 1987-1990 to 51 per cent during 1995-2002, while percentages in purchases increased from 50 per cent to 63 per cent (UNCTAD, 2003b). The growing significance of cross-border M&As by EU firms was triggered by the Single Market Programme (i.e. Europe 1992) and the global restructuring of industries, which led EU firms to acquire US companies, especially in the second half of the 1990s. The rapid expansion of Japan's FDI in the US in the second part of the 1980s took place, in part, through acquisitions of US companies, the most prominent among them being the acquisition of the Rockefeller Center in New York and film studios in Hollywood (UNCTAD, 2000b: 160). Today, cross-border M&As, once seen as a tool of global expansion of US TNCs, are used as a convenient mode of FDI entry by TNCs from virtually all developed countries. Key reasons behind the overwhelming importance of M&As as a mode of FDI entry to developed countries are considered to be the advantages of speed and access to proprietary assets that M&As provide which allow foreign investors to build strong positions in new markets. Other reasons, such as financial gains to be exploited and personal objectives of managers, may play a role as well (see Module 1, theme 3 on the determinant of FDI).

During the late 1990s, developing host countries (and transition economies) emerged as visible recipients of FDI in the form of cross-border M&As: their share in the value of cross-border M&As world-wide increased from 2 per cent in 1987 to 9 per cent in 1999 (UNCTAD, 2000b: 122) and 15 per cent in 2006 (UNCTAD, 2007: 271). Initially, privatization in Latin America and the Caribbean, notably in Brazil and Argentina, as well as in transition economies, was the main vehicle for attracting FDI through M&As into developing countries. As a result of the financial crisis, in Asia, a rapid rise in cross-border sales of companies took place in the second half of the 1990s. For example, acquisitions by foreign firms in the Republic of Korea exceeded US$9 billion in 1999 (UNCTAD, 2005b: 122). In Africa, cross-border M&As have been rare and focused on few countries including Egypt, Morocco and South Africa. With privatization programmes in many developing countries completed, and the financial crisis in Asia over, the role of M&As as a

[5] Although the term "M&A" is commonly used to depict the phenomenon, in practice almost all cross-border M&As – 97 per cent of the total, by number, are acquisitions (UNCTAD, 2000b: 99). Most mergers, assumed to combine the assets and operations of two companies on an equal basis, are, in fact, acquisitions. They typically end up with one company controlling the other.

[6] This is because the two data series, on cross-border M&As and FDI flows, although measuring similar phenomena, do so in different ways. More specifically, if company A from a home country acquires company B in a host country, the whole value of the transaction (on an announcement or a completion basis) would be recorded in a given year by an M&A database, even though actual payments can be phased over several years or the actual value of the transaction can differ from the announced one. FDI data will record only the part of the transaction financed by parent company's own funds used to acquire equity capital of company B or to extend a loan to this company. Furthermore, only actual payments in a given year would be registered. In addition, FDI data would not register the transaction at all if it were financed by a loan raised in the capital market of the host country (for more on this topic, see UNCTAD, 2000b: 104-106).

[7] In developed host countries with well-developed financial markets, foreign firms often borrow from local financial markets to finance their M&As in those countries, so that the value of cross-border M&As can exceed that of FDI flows entering through the M&A mode.

form of FDI entry typically dwindled, resulting in reductions of FDI inflows into some of these countries. For example, FDI inflows into Brazil soared to around US$30 billion annually at the height of the country's privatization programme, during 1998-2000, this settled at US$10-15 billion during 2002-2004, with the privatization programme largely completed (UNCTAD, 2005a: 6).

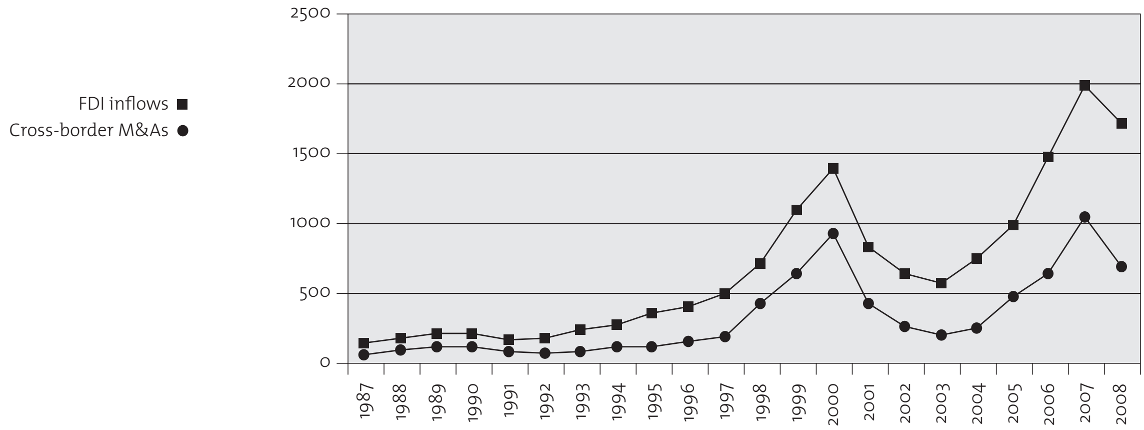
Given the strong correlation between FDI flows and M&As, the rhythm and fluctuations of the two follow a similar pattern. When M&As fall, as they, for example, drastically did during the economic slowdown of 2001-2002, FDI flows fell as well. When M&As started recovering in 2004, so did global FDI flows.

Figure 5

Cross-border M&As and FDI flows, 1987-2006 (billions of US dollars)

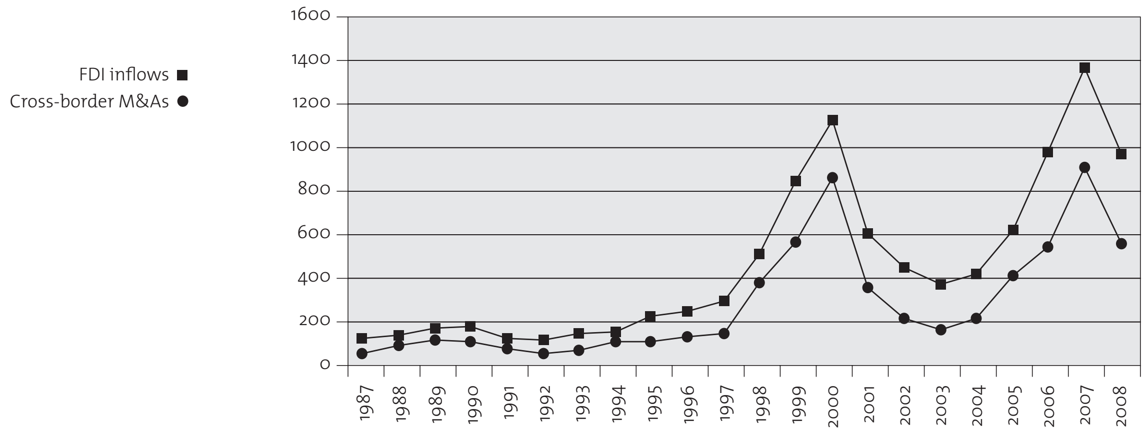
Cross-border M&As drive FDI flows...

5a | Global FDI inflows and cross-border M&As



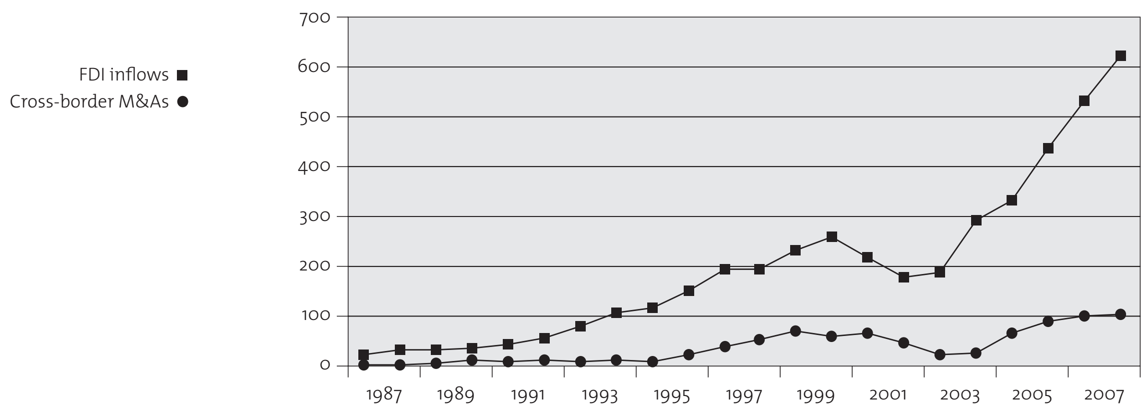
... but more so in developed countries...

5b | Developed countries: FDI inflows and cross-border M&As



... than in developing countries.

5c | Developing countries: FDI inflows and cross-border M&As



Source: UNCTAD, FDI/TNC database.

Cross-border M&As, particularly those involving large firms, vast amounts of money and major restructuring, are among the most visible features of globalization. Not only do they dominate FDI flows in developed economies, they have also begun to take hold as a mode of FDI entry into developing and transition economies. As with globalization generally, the impact of M&As on host countries can be double-edged and uneven. Indeed, perhaps to a greater extent than many other aspects of globalization, cross-border M&As, and the expanding global market for firm ownership and control in which they occur, raise questions about the balance of their benefits and costs for host countries. These questions arise despite the fact that governments generally welcome inward FDI in their countries.

Concerns are expressed in political discussions and the media in a number of host countries say that acquisitions as a mode of entry are less beneficial for economic development than greenfield investment. At the heart of these concerns is the fact that foreign acquisitions (mergers, as noted earlier, are rare) do not add to productive capacity at the time of entry, but simply transfer ownership and control from domestic to foreign hands. This transfer is often accompanied by lay-offs and/or the closing of some production or functional activities (e.g. R&D); it entails servicing the new owner in foreign exchange; and, if the acquirers are global oligopolists, it may well lead to market dominance. In fact, cross-border M&As can be used to reduce competition in domestic markets. They can lead to strategic firms or even entire industries (including key ones like banking) falling under foreign control, threatening local entrepreneurial and technological capacity-building.[8] The concerns are not only economic, but also social, political and cultural. In industries like media and entertainment, M&As may seem to threaten national culture or identity. A large shift of ownership of important enterprises from domestic to foreign hands may even be seen as eroding national sovereignty and amounting to recolonization.[9] When acquisitions involve "fire sales" (sales of companies in distress, often at prices viewed as abnormally low) concerns become particularly acute. All these concerns can create the impression that greenfield FDI is "good", while FDI through cross-border M&As is "bad".

These concerns are further accentuated when they are placed in the broader context of globalization, rapid change, marginalization of some economies or groups within economies, and increasing inequality. TNCs are thought to benefit disproportionately from globalization, while local SMEs in developing countries are perceived as being affected adversely. M&As, particularly in their cross-border form, appear to be little more than a vehicle for the expansion of big business. Concerns over cross-border M&As are by no means confined to developing countries. They are also expressed in many developed countries, sometimes more vehemently. When Japanese investors acquired Rockefeller Center in New York City and film studios in Hollywood, the US media reacted with indignation.[10] More recently, when Vodafone AirTouch (United Kingdom) sought to acquire Mannesmann (Germany), there was again indignation in some quarters. While nationalistic reactions to foreign takeovers are diminishing in force, they can be strong enough to lead host governments to intervene, particularly if takeovers are hostile.

A dispassionate analysis of the effects of cross-border M&As on development is therefore needed to shed light on the validity of these concerns, and especially on the validity of the view that greenfield FDI is better than FDI through M&As. Such an analysis must be based on an understanding of the driving forces of cross-border M&As and their global context, in particular, the emergence of a global market for firms. It must, moreover, take into account not only the immediate impact of FDI through M&As but the impact over time (refer to UNCTAD, 2000b, examining the impact of FDI through M&As on the development of host countries).

4 The growth of non-equity relationships

Traditionally cross-border agreements, or non-equity[11] relationships or arrangements between firms in different countries have played an important role in the global expansion of firms, beyond FDI, as an equity form of international production. Technology licensing and other forms of non-equity participation providing access to TNCs' technologies, such as original equipment manufacture (OEM) that gives host country firms the right to use TNCs' brand names, have been important in some manufacturing industries. In several service industries, non-equity arrangements have been more important than equity-based forms. International restaurant networks, especially fast-food networks, car rentals and retail trading networks have been frequently based on franchising agreements. Management contracts are used in the hotel industry (together with equity forms) and partnerships rather than equity links in business services such as accounting, business consultancy, engineering or legal services. Globalization has led to an explosive growth of international agreements among firms, with their range growing ever wider. Now they are part and parcel of interna-

[8] For example, in Brazil, in 1996 and 1997, a number of TNCs acquired several large domestic auto parts producers. Subsequently, the R&D activities of the local firms were downgraded, and the frontier research was relocated to the parent firms' R&D centres in their home countries (UNCTAD, 1999: 202). One study has even concluded that "most of the local innovative firms have been acquired by TNCs subsidiaries that, as part of their strategies, are downgrading the technological activities carried out locally" (Cassiolato and Lastres, 2002: 1).

[9] In Latin America, for example, extensive purchases of local firms by Spanish investors have been dubbed *reconquista* (see "New world conquest", *Time*, 1 May 2000: 67-68), and the sale of well-known firms to foreign investors has generally aroused concern (see for example, "The nationalist groundswell in Brazil", *The Economist*, 26 February 2000: 67-68).

[10] The purchases of the Center and the studios – Columbia Pictures and Tristar Pictures – proved to be bad investments. Both suffered losses soon after the purchase. The Center was repurchased by US investors in the mid-1990s (UNCTAD, 2000b: 207).

[11] Non-equity forms of investment include, *inter alia*, subcontracting, management contracts, turnkey arrangements, franchising, licensing and productsharing. Note: Other non-equity relationships are not forms of investment.

tional production, complementing traditional FDI, and in particular M&As, as a form of restructuring of resources and capabilities of firms in response to globalization. The number of such agreements (excluding technology agreements and including joint ventures) concluded annually, increased from 1,760 in 1990 to 4,600 in 1995 (UNCTAD, 1997: 12).

Inter-firm agreements today serve a variety of corporate objectives. Two motivations stand out as particularly important. The first is knowledge-sharing/better access to technology generated by other firms. This allows firms to accelerate innovation and share the cost and risk of innovative activities. The second is streamlining resources and capabilities of firms, by focusing on core competencies. The first motivation has boosted technology agreements (including strategic alliances) while the second has given rise to outsourcing of non-core activities to other firms, more and more frequently located in other countries and linked to international production systems through non-equity arrangements.

Over the period 1980-1996, a total of 8,254 inter-firm technology agreements were recorded, with their number growing from an annual average of less than 300 in the early 1980s to over 600 in the mid-1990s (UNCTAD, 1998: 23). Industries that are highly knowledge-intensive have the largest number of agreements. From 1980-1996, information technology was the top industry, accounting for 37 per cent of all agreements. Pharmaceuticals, and in particular bio-pharmaceuticals, were another important industry, with a 28 per cent share in 1996 (up from 14 per cent during 1980-1983). In less knowledge-intensive industries, including the food and automotive industries, the number of agreements peaked in the mid-1980s. Agreements have declined in both of these industries since then, but rose again in the food industry in the first half of the 1990s. Triad members (EU, Japan and the US) are dominant partners in these agreements. By the mid-1980s, 86 per cent of these agreements had at least one US partner, 42 per cent one EU partner, and 31 per cent one Japanese partner. The participation of developing country firms increased from 3 per cent in 1989 to 13 per cent in 1995.

The rise in technology agreements reflects drastic changes in the technological environment of firms since the mid-1980s, which evolved from being reasonably predictable and stable to much more dynamic and variable. Some of these adjustments include: patterns of demand changing more rapidly than before, faster innovation reducing product life cycles, product development times becoming shorter and more flexible and new manufacturing techniques putting additional pressure on firms. All of these adjustments increase cost and heighten uncertainty, while at the same time technology increases in importance as the key competitive asset of firms. Initially firms turned to M&As for assembling the critical mass of technological resources to stay competitive. But M&As have frequently proved to be insufficiently flexible, hence firms have resorted to agreements: often firms do not want to acquire, or gain access to, all the assets of other firms, but only those that enhance their competitiveness (Dunning, 1995: 139).

Two caveats need to be made here. One is that it does not seem that inter-firm agreements replace FDI, or, for that matter M&As. Indications are that both go hand-in-hand, complementing each other rather than acting as substitutes (UNCTAD, 1998: 24). The second caveat is that technology, although very important, is not the only asset sought in inter-firm agreements, and consequently, technology agreements are not the only agreements on the rise. Gaining access to new markets or distribution channels and capturing economies of synergy or scale can be no less important for many firms, giving rise to a myriad of inter-firm agreements.

A striking recent trend in the governance of international production systems in manufacturing and services (see the section on the sectoral distribution of FDI) is the focus of "core competencies", or activities in which "TNCs can deploy proprietary advantages, wield market power and, consequently, enjoy higher returns" (UNCTAD, 2002: 122). This has lead to larger outsourcing of a wider range of activities and has given rise to further growth of non-equity forms of international production beyond alliances or partnerships. The outsourcing trend creates even more complex structures of international production. In particular, leading TNCs have begun to exit from manufacturing altogether, giving way to the emergence of contract manufacturers that specialize exclusively in manufacturing for other firms, especially TNCs. Contract manufacturing differs from earlier non-equity forms such as original equipment manufacturing in that brand-holding TNCs do not simply draw on subcontractors for extra production capacity, but outsource the entire manufacturing function for individual product lines or, in some cases, such as Cisco systems, the entire product range.

Contract manufacturing is difficult to capture statistically. Some figures for the electronics industry give a broad idea of the magnitude involved. Between 1998 and 2002 the global market for this type of activity was expected to increase by 140 per cent, from US$58 billion to US$139 billion. Estimates were that the share of contract manufacturing in electronics would increase from 8 per cent in 1999 to 18 per cent in 2004. The largest four contract manufacturers each had revenues of over US$10 billion in 2002 – two US firms, one Canadian and one Singaporean (UNCTAD, 2002: 139). These firms had facilities all over the world, in developed, developing and transition economies.

As market imperfections that encourage internalization still exist, shedding assets or activities leads, more often than not, to equity and non-equity forms of international production instead of “arm’s length trade”. Therefore, "the strategic need to maintain influence over the design, quality and supply of inputs, the processing of downstream activities and the pace and direction of innovation is even greater" (Dunning, 1995: 139). Thus, even though international production systems based on non-equity arrangements are increasing, TNCs typically exert significant authority over such systems through controlling key functions, such as brand management and product definition, as well as through the setting and enforcing of technical, quality and delivery standards throughout the network of formally independent producers.

5 The sectoral composition of FDI

Rapid growth of FDI in the recent past has been driven largely by FDI in services. As a result, the sectoral composition of global FDI has shifted towards services, accompanied by a decline in the share of FDI in the primary sector and manufacturing in which it was concentrated in the 1950s. (The latter FDI was of a market-seeking type, motivated by access to national markets, often sheltered from international competition by trade barriers.) Since 2004, however, FDI in the extractive industries of resource-rich countries has seen increased activity and its importance in infrastructure services is also rising.[12] This renewed interest reflects the structural shift that is occurring in the relative importance of various markets in the world economy. Rising demand for mineral resources from fast-growing markets in Asia has added to the levels of demand in developed countries, leading to an increase in mineral prices. As a result, corporate profits in the extractive industries attracted FDI (see box 12).

[12] FDI flow data for recent years suggest that the share of the primary sector is partly recovering and could eventually reach its 1990 level. The sector accounted for 12 per cent of world FDI inflows in 2003-2005, compared with 7 per cent in 1989-1991 (UNCTAD 2007: 22).

Box 12

FDI in extractive industries on the rise again

In the early twentieth century, extractive industries accounted for the largest share of FDI, reflecting the international expansion of firms from colonial powers. After World War II the share of extractive industries in global FDI declined. From the mid-1970s, in particular, the share of oil, gas and metal mining in world FDI fell steadily as other sectors grew much faster.

The recent increase in FDI in extractive industries has been driven by high prices of metals, oil and natural gas. High prices have spurred an investment boom in mineral exploration and extraction. For example, global private investment in non-ferrous metal exploration rose from US$2 billion in 2002 to an estimated US$7 billion in 2006, and drilling for oil and gas doubled over the same period. Note, however, that although by June 2007, prices of commodities such as aluminum, copper, gold and oil remained close to their highest levels in nominal terms, their future trends are difficult to forecast. Nevertheless, since experts agree that the costs of exploiting new mineral deposits are likely to rise; prices might be kept at relatively high levels in the coming years.

The list of the most prominent host countries of FDI in extractive industries is quite diverse. Developed countries attract the bulk of such FDI, partly explained by significant cross-border M&A activity, however, their share in global inward FDI in these industries fell from about 90 per cent in 1990 to 70 per cent in 2005. The share of developing and transition economies as destinations for TNC investments in extractive industries has increased over the past two decades. Between 1990 and 2005, their estimated combined stock of inward FDI more than tripled. Following new mineral discoveries, a number of new FDI recipients have emerged, including least developed countries (LDCs) such as Chad, Equatorial Guinea and Mali. During this period, the Russian Federation and other Commonwealth of Independent States (CIS) members also became important destinations for FDI in extractive industries.

The importance of extractive industries in inward FDI varies by host economy. In all the major country groups, the extractive industries of some countries account for a significant share of the total inward FDI stock: for example, Australia, Canada and Norway among developed countries; Botswana, Nigeria and South Africa in Africa; Bolivia, Chile, Ecuador and Venezuela in Latin America and the Caribbean; and Kazakhstan in South-East

Box 12

FDI in extractive industries on the rise again

Europe (SEE) and the CIS. In a number of low-income, mineralrich countries, extractive industries account for the bulk of inward FDI; many have few other industries that can attract significant FDI, due to their small domestic markets and weak production capabilities.

The relative importance of foreign companies in the production of metallic minerals and diamonds varies considerably by country. Foreign affiliates account for virtually all of the (non-artisanal) production in LDCs such as Guinea, Mali, Tanzania and Zambia, as well as in Argentina, Botswana, Gabon, Ghana, Mongolia, Namibia and Papua New Guinea. In these countries, TNCs generally operate through concessions granted in the form of exploration and mining licenses. In another 10 major metal-producing countries, foreign affiliates account for an estimated 50 to 86 per cent of production. By contrast, in the Islamic Republic of Iran, Poland and the Russian Federation their share is negligible.

In oil and gas, foreign affiliates generally account for a lower share of production than in metal mining. In 2005, they were responsible for an estimated 22 per cent of global oil and gas production, with the average share being higher in developed countries (36 per cent) than in developing countries (19 per cent) and transition economies (11 per cent). However, there was wide variation among developing countries. In West Asia, foreign affiliates' output amounted to an average of only 3 per cent of production, whereas the corresponding share in sub-Saharan Africa was 57 per cent on average. Foreign companies accounted for more than half of production totals in Angola, Argentina, Equatorial Guinea, Indonesia, Sudan and the United Kingdom. On the other hand, no production was attributed to foreign affiliates, for instance, in Kuwait, Mexico and Saudi Arabia.

Source: Based on UNCTAD (2007: xxi-xxii).

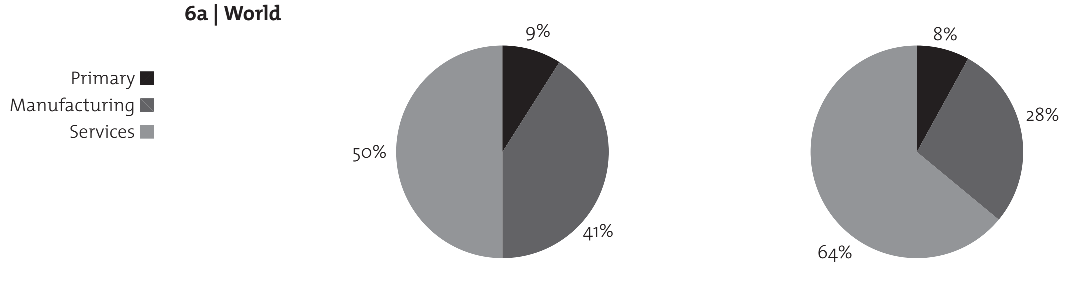
Nonetheless, the long-term shift towards services has been consistent over time. Services represented less than a quarter of the stock of FDI of major home and host countries at the beginning of the 1970s, 40 per cent in 1985 and almost a half in 1990 (Mallampally and Zimny, 2000). The shift continued into the 1990s and 2000s. The share of the services sector in 2007 represents almost two thirds of the world FDI stock. In inward FDI the importance of services has increased in both developed – up from 49 per cent in 1990 to 64 per cent in 2007 – and developing countries – up from 48 per cent to 70 per cent from (figure 6).

In contrast, the share of manufacturing in global FDI inward stock fell to 28 per cent in 2007, from 41 per cent in 1990. The decline was slightly larger in developing countries – where it reached 24 per cent in 2007 – than in developed countries where it was 28 per cent. The share of the primary sector also declined, from 9 per cent to 8 per cent. It is lower in developing countries (6 per cent) than in developed countries (8 per cent) and in the transition economies of SEE and the CIS (20 per cent). The highest share of FDI in primary industries has been in mining and petroleum.

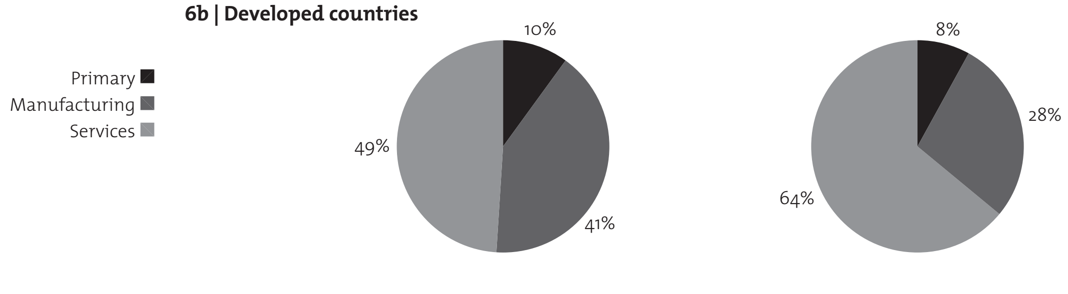
Figure 6

The sectoral composition of FDI: shift towards services, 1990 and 2007

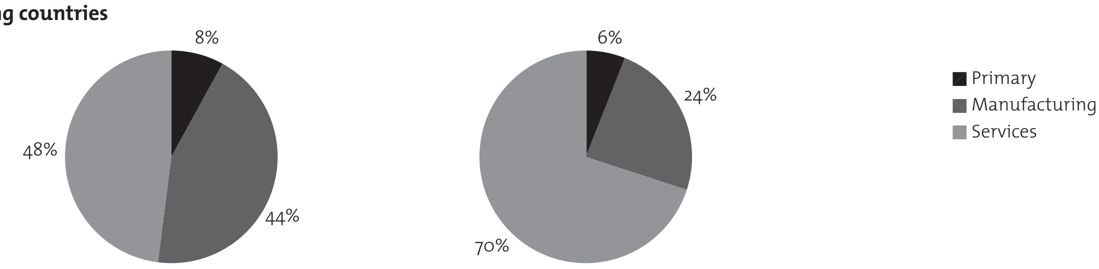
6a | World



6b | Developed countries



6c | Developing countries



Source: UNCTAD (2009: 218).

The long-term shift towards services FDI has been primarily due to FDI in non-tradable services, which, because they are not transportable or storable, have to be produced where they are consumed. FDI is often the only means of delivering these services to foreign markets. In addition, with regard to some services (such as insurance services or retail banking) which technically could be traded, host-country regulations often require local establishment for their delivery. Initially, two service industries dominated services FDI – financial and trading. This reflected the early international expansion of trading companies (e.g. Japanese sogo shosha and Western European traders) and transnational banks following their customers abroad. In addition, manufacturing and primary sector TNCs were used to establish foreign affiliates in these services in support of trade and other operations abroad. Although investments in these services continue, they are not as dynamic as those in other non-tradable services such as electricity (which registered a 19-fold increase in inward FDI stock between 1990 and 2005), telecommunications and transport (a nearly 16-fold increase)[13] and business services (including also real estate, a ten-fold increase). As a result, finance and trading FDI stock decreased from 65 per cent of all inward services stock in 1990 to 48 per cent in 2003, while that of the "new" FDI service industries rose from 17 per cent to 38 per cent[14] (UNCTAD, 2005b: 260).

A boost in investment in services, including in the "new" service industries, occurred when both developed and developing countries started revising their policies towards the services sector in the second half of the 1980s, followed by transition economies in the 1990s. Governments set in motion a process of liberalization of policies with respect to domestic as well as international production and provision of services. Domestic as well as foreign competition have been increasingly viewed as tools for raising the efficiency and productivity of service industries, which in turn are being recognized as critical for economic performance. Deregulation and privatization of service industries (in particular infrastructure services such as telecommunications, power generation, transportation and the provision of water) followed which was coupled with countries (including developed countries) opening up to FDI. On the international front, the creation of the Single Market in the EU provided a powerful inducement for both EU and non-EU TNCs to invest in service industries of the EU countries. The completion of the Uruguay Round and the adoption of the General Agreement on Trade in Services (GATS) provided an additional channel for further liberalization of developing and transition countries' policies related to FDI in services, however, the strongest impetus for FDI growth in services came from the privatization programmes in developing and transition economies, notably in Latin America and Central and Eastern Europe.

Notwithstanding the rapid growth in services FDI, the degree of the transnationalization of the services sector as measured by the transnationalization of service firms and the service sectors of host countries through FDI still lags behind that in the manufacturing sector (Mallampally and Zimny, 2000; UNCTAD, 2004: xxii). The scope for further expansion of FDI in non-tradable services remains considerable. Prospects for services FDI have been further enlarged by advances in information technology and communication technologies, which have greatly enhanced the ability for processing and transporting information between geographic locations and, consequently, for the cross-border tradability of information-intensive services or parts thereof. As a result of this "tradability revolution" we are witnessing a fragmentation of the production of some services by TNCs in all sectors and its relocation to developing and transition economies, resembling the process that took place in labour-intensive manufacturing some 20-30 years ago. According to a recent survey of the world's largest companies by A.T. Kearney, a global business consultancy firm, in the near future nearly 80 per cent of cross-border outsourcing (also called off-shoring of business-services), leading to export-oriented FDI and non-equity arrangements, will take place in services such as information technology (IT) support, back office functions, R&D, call centres, distribution and logistics and treasury operations (Global Business Policy Council, 2003: 5-6). According to UNCTAD,

[13] This increase took place mainly in telecommunications and was related to privatization of telecommunication services in many countries open to FDI. Growth of FDI in electricity was also related to privatization, while FDI in transport is rather small.

[14] Other dynamic services include health services and education where stock increased by 12 and five times respectively over the same period, but the absolute size of the stock in these activities is still very small.

"while the off-shoring of services is still in its infancy, the tipping point may be approaching rapidly. Off-shoring represents the cutting edge of the global shift in production activity, giving rise to a new international division of labour in the production of services" (UNCTAD, 2004: xxiv).

TNCs in agricultural production and development: Foreign participation can play a significant role in agricultural production in developing countries, which are in dire need of private and public investment, thereby boosting productivity and supporting economic development and modernization.

FDI flows in agricultural production tripled to US$3 billion annually between 1990 and 2007, driven by the food import needs of populous emerging markets, growing demand for biofuel production, and land and water shortages in some developing home countries. These flows remain small compared to the overall size of world FDI, but in many low-income countries agriculture accounts for a relatively large share of FDI inflows; and the latter are therefore significant in capital formation in the industry. Moreover, FDI in the entire agricultural value chain is much higher, with food and beverages alone representing more than US$40 billion of annual flows.

Contract farming activities by TNCs are spread worldwide, covering over 110 developing and transition economies, spanning a wide range of commodities and, in some cases, accounting for a high share of output.

Developed-country TNCs are dominant in the upstream (suppliers) and downstream (processors, retailers, traders) ends of the agribusiness value chain. In agricultural production, FDI from the South (including South-South flows) is equally significant as FDI from the North.

TNC participation in agriculture in the form of FDI and contract farming may result in the transfer of technology, standards and skills, as well as better access to credit and markets. All of these could improve the productivity of the industry – including the farming of staple foods – and the economy as a whole. Moreover, TNCs' contribution to food security is not just about food supply; it also includes enhanced food safety and affordability. These depend on the right policies for host countries to maximize benefits and minimize the costs of TNC participation.

Governments should formulate an integrated strategic policy and regulatory framework for TNC activities in agricultural production. This should include vital policy areas such as infrastructure development, competition, trade and trade facilitation, and R&D. It is equally important to address social and environmental concerns regarding TNC involvement.

Governments could also promote contract farming between TNCs and local farmers in the direction of enhancing farmers' predictable income, productive capacities and benefits from global value chains. To protect the interests of farmers, governments could develop model contracts for them to use or consider when negotiating with TNCs.

To ensure food security in host countries as a result of export-oriented FDI in staple food production by "new investors", home and host countries could consider output-sharing arrangements.

In order to address the concern about "land grab", the international community should devise a set of core principles that deal with the need for transparency in large-scale land acquisitions, respect for existing land rights, the right to food, protection of indigenous peoples, and social and environmental sustainability.

Public-private partnerships can be an effective tool for bringing a "new green revolution" to Africa. One initiative in this regard is seed and technology centres that adapt seeds and related farming technologies to local needs and conditions, distribute them to local farmers, and build long-term indigenous capacities.

6 Changing geography of FDI

6.1 Home countries: less concentration

During the two decades after World War II, outward FDI was dominated by the US and a few former colonial powers of Western Europe. In 1960, four countries accounted for over four fifths of the world outward stock of FDI. The US was the largest home country holding around half of the world stock, followed by the United Kingdom – 18 per cent, the Netherlands – 10 per cent and France – 6 per cent (figure 7 and UNCTAD, 1988: 24). Almost all FDI originated from developed countries.

During the decades that followed, the geographical composition of outward FDI became more diverse, especially among developed countries. The dominance of the four countries just mentioned, subsided to around two-thirds of world stock during the early 1980s and 50 per cent during the 1990s and into the early 21st century. Their relative decline occurred, however, almost entirely on account of the declining share of the US, to one fifth of global FDI stock in 2008. The share of the three remaining countries was lower in 2008 to that in 1960, fluctuating during the intervening decades around one quarter.

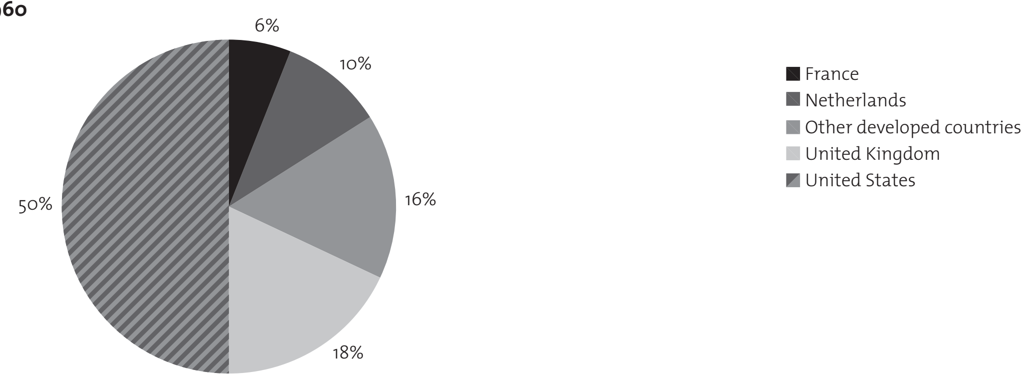
The geographical composition of FDI from developing and transition economies has changed over time, the most notable long-term trend being the steady growth of developing Asia as a source of FDI. (UNCTAD, 2006: xxiii)

Figure 7

Home country composition of FDI, 1960 and 2008

1960 – few sources of FDI

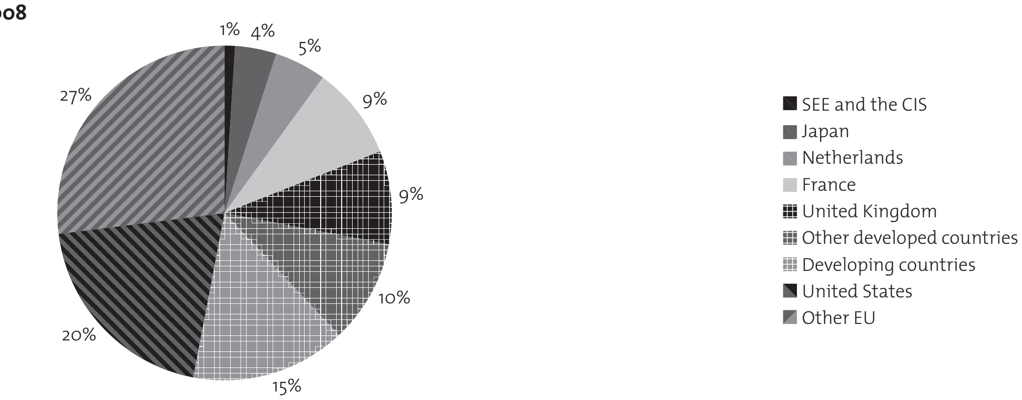
7a | World FDI outward stock, 1960



Source: UNCTAD, FDI/TNC database.

Many sources of FDI, including developing countries

7b | World FDI outward stock, 2008



Source: UNCTAD, FDI/TNC database.

The US remains the largest home country in the world, but its lead has largely diminished. The large decrease in the US share (figure 7) is due to new major global players as well as a group of smaller investor-countries, which have stepped up their foreign investments over the past few decades. Key changes are as follows:

- **The rise and fall of Japan's role.** With regard to individual countries, the largest upsurge in foreign production originated from Japanese TNCs, which increased their investment abroad sharply, particularly in the US in the 1980s and Europe in the 1990s. Between 1980 and 1994 Japanese outward FDI stock increased 14 times, and Japan's share in world FDI stock rose from 3.5 to 12 per cent. In the early 1990s, Japan outpaced the United Kingdom and had the second largest outward stock, but with prolonged stagnation in economic growth during the 1990s, Japan lost its position and its share declined to some 4 per cent by 2008. Japan, however, remains a significant home country in terms of the absolute size of FDI stock (ranking eighth in the world).

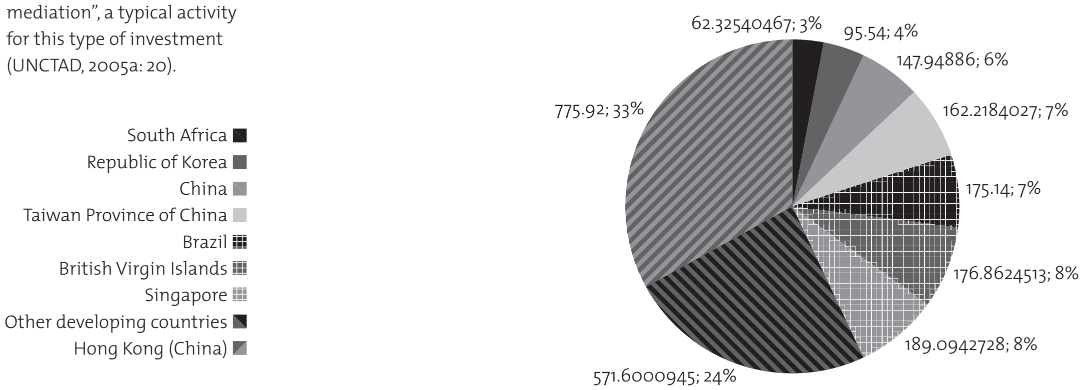
- **Emergence of TNCs from developing countries.** Another significant change was the emergence of TNCs based in the developing world. In the 1970s and 1980s their investment was about 3 per cent of the world total (UNCTC, 1988: 24). This was mainly trade supporting FDI and investment in services catering to the needs of emigrants from these countries. Between 1987 and 2005, their share of global cross-border M&As rose from 4 per cent to 13 per cent in absolute terms, and from 5 per cent to 17 per cent in terms of agreements concluded. Almost all the increase originated in a few newly industrializing Asian economies, including the Republic of Korea, Taiwan Province of China, Singapore and Hong Kong (China), which displayed a regional "flying-geese pattern" – when these countries started losing comparative advantage in unskilled labour-intensive manufacturing, their firms moved out to seek more competitive locations in the region, this has taken place more recently in China in which Hong Kong (China) is by far the largest investor. Automotive and electronics TNCs from these countries also undertook a number of investment projects in developed countries. The developing countries' share of all recorded greenfield and expansion projects exceeded 15 per cent in 2005 and the total number of parent companies in Brazil, China, Hong Kong (China), India and the Republic of Korea has multiplied, from less than 3,000 to more than 13,000 over the past decade. As a result of the emergence of developing-country TNCs (and recently TNCs from transition economies, although still on an insignificant scale), the share of the world stock of FDI held by TNCs based in developed countries decreased to below 90 per cent.

The most notable long-term trend is the steady growth of developing Asia as a source of FDI. Figure 8 shows the eight largest home developing countries which accounted for 81 per cent of developing countries' total outward FDI stock in 2008. Apart from Asian countries, mentioned above, it also includes the British Virgin Islands and Brazil. The former owes its position on the list to its status as a financial centre (and tax haven), encouraging many TNCs to register their affiliates or even headquarters there for tax reasons. (A number of other Caribbean States have a similar status and also attract TNCs for tax reasons). Brazil's foreign investment is partly genuine FDI (that is, FDI attributable to international production by Brazilian TNCs) and partly investment in tax havens for tax reasons.[15]

[15] Almost three quarters of Brazilian outward FDI is located in tax haven economies and more than half of the total is in "financial intermediation", a typical activity for this type of investment (UNCTAD, 2005a: 20).

Figure 8

The largest home developing countries for FDI, 2008



Source: UNCTAD, FDI/TNC database.

Note: Outward FDI stock in billions of United States dollars and per cent share in the total outward stock of developing countries.

- **The European Union takes the lead.** The European Union (15) has strengthened its position in world outward investment considerably, increasing its share from 38 per cent in 1980 to 45 per cent in 1990 and 52 per cent in 2006. While in 1980 the EU's stock was similar to that of the US, by 2006 it was 2.7 times larger. The three mature investing countries mentioned earlier (France, the Netherlands and the United Kingdom) as well as Germany dominate EU stock, accounting for 34 per cent out of the Union's 52 per cent. Out of the 14 percentage points of the EU's increased share in world stock, the three mature investing countries are responsible for less than 3 percentage points (this is accounted for primarily by France). Germany joined the group of the largest EU home countries before the 1980s, and since then it has kept its status, with its share stable at around 7-9 per cent of world stock. The biggest gain came from "newcomers" to the EU, the group of countries that joined the EU in various years between 1973 and 1995 (including Denmark, Ireland, Portugal, Spain, Austria, Finland and Sweden) which shared almost 7 percentage points, as well as the balance from Belgium-Luxembourg (whose FDI data is reported together) and Italy. All in all, out of the 15 members of the EU (prior to its expansion in 2004 to include some Central and Eastern European countries) 10 increased their shares of global FDI stock between 1980 and 2001, two (the United Kingdom and Germany) maintained their shares and only one (Greece) decreased its share. France and Spain registered the largest gains, 3.5 and 3 percentage points respectively, followed by Italy with 1.6 points and Sweden with 1.3 points (leaving out the special case of Luxembourg and, consequently, Belgium because of the joint reporting of FDI data).[16]

6.2 Host countries: more balanced distribution

Inward FDI stock has always been much less concentrated than outward stock. While, as mentioned earlier, in the 1960s, almost all FDI originated in developed countries, 70 per cent of it went to developed countries and the balance to developing ones (Dunning, 1993: 20). The reason is that while outward FDI requires a pool of companies with ownership-specific advantages, which only a small group of developed countries have, many more countries have some location advantages (such as natural resources, competitive labour force or large and/or dynamic markets) – a condition to attract FDI. Therefore, the field of inward FDI is much more crowded than that of outward FDI. Over time, competition for FDI among countries has intensified as more countries have opened up to FDI and actively sought to attract it. During the 1990s, competition was more intense than during the 1980s. China and transition economies entered the picture, India started to seek FDI more actively than before, Brazil, the largest host developing country in the 1960s and 1970s, overcame the economic crisis that affected it in the 1980s, and a number of regional integration schemes came to life, creating large regional markets – always an attraction to foreign investors – North American Free Trade Agreement (NAFTA) or Southern Common Market (Mercosur). In this situation it has become more difficult for individual host countries to increase or even maintain their share in world FDI. Indeed, the country composition of inward FDI has undergone significant changes, compared to that of earlier decades. Given the turbulent developments with respect to FDI, many of these changes were short-lived and gave way to new ones. Key long-term changes were as follows:

- **The US becomes the largest host country.** During the 1960s and 1970s the US was a large host country (with its share of the total inward stock around 9-10 per cent), but it was not the largest one – Canada was. In 1979 the US replaced Canada in this role (Dunning, 1993: 21) and became, during the 1980s, far and away the largest host to FDI, accounting between 1990 and 2000, for one fifth of the world total (the United Kingdom was next with 10 per cent). Since then, the US has maintained its share and its distance from other large host countries. In 2006, with the stock of US$1.8 trillion, it still accounted for 15 per cent of the world's total stock. The United Kingdom was second (US$1.1 trillion) and France third (US$783 billion) (UNCTAD, 2007: 255).

- **China emerges as a leading host country.** Among the most significant changes in the distribution of inward FDI over the past two decades has been the rise of China to the position of the fourth largest recipient of FDI in the world, from 17th place in 1980 and 1990. This rise occurred during the 1990s, when China increased its share of world FDI stock from 1.2 per cent in 1990 to 6.3 per cent in 2002 – a 5 percentage-point increase not matched by any other country of the world, inflating developing countries' share in inward investment. The greater part of FDI in China originated from the developing countries of Asia, particularly Hong Kong (China),[17] and continues to do so. With regard to FDI inflows, in the early 21st century, China has consistently been among the top host countries in the world. In 2006, with an inflow of $69 billion, it ranked fourth in the world, behind the US, the United Kingdom and France (UNCTAD, 2007: 251; see also figures 10 and 11).

- **CEE emerges as a new host region.** Central and Eastern Europe (CEE) emerged during the 1990s as a new destination for FDI, increasing its share in inward FDI stock from virtually zero per cent in 1990 to 2.6 per cent in 2002. Most of this increase was accounted for by the eight countries that became members of the EU in 2004.[18] These countries account for the bulk of FDI stock in the region, although their share decreased from 78 per cent in 1995 to 71 per cent in 2002. The CEE combined stock of FDI, US$190 billion in 2002, was still small. It was not much larger than that of Ireland (US$160 billion) and was smaller than that of Brazil (US$235 billion).

- **European Union (15) increases and maintains its share.** The EU posted gains with regard to inward FDI, although they were not as big as in the case of outward FDI. Between 1980 and 2001, the EU increased its share of global stock from 31 per cent to almost 37 per cent. All of these gains took place during the less competitive decade of the 1980s. Since 1990, the EU has been able to, more or less, maintain its share amidst increasing competition for FDI and accelerating FDI growth: from 1980 to 1990 global FDI stock increased 2.8 times and between 1990 and 2000, 3.2 times. Between 1980 and 2001, out of 14 EU members (Belgium and Luxembourg counted as one), nine (all founding members) registered increases in their world

[16] Luxembourg is a special case because it is a host to a large number of foreign holding companies established there for tax reasons. These companies are used to channel funds between affiliates and parent companies of TNCs located in different countries in order, for example, to acquire foreign companies. As a result, according to FDI data, Luxembourg emerged in 2002 as the world's largest outward investor and the largest FDI recipient, accounting for about 19 per cent (US$124 billion) of world inflows and 24 per cent (US$154 billion) of outflows. Only a small part of these flows represents genuine FDI (UNCTAD, 2003b: 69).

[17] Part of this investment, an estimated 25 per cent, is due to so-called "round-tripping", i.e. capital outflow from China reinvested back into China to receive privileges accorded by China to foreign direct investors.

[18] They are Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

shares, two (Austria and Portugal) showed no change and the shares of three countries (Greece, Ireland and the United Kingdom) decreased. It is interesting to note that the Netherlands, which lost some clout (through losing shares) as an outward investor, increased consistently its share of global stock from 2.7 per cent in 1980, to 3.5 per cent in 1990 and 3.8 per cent in 2006, thus becoming the fourth largest host country in the EU, after the United Kingdom (9.5 per cent share), France (6.5 per cent share) and Germany (4.2 per cent of world inward stock). Although the US remains by far the largest single host country in the world, the EU is the largest host region, with its stock triple that of the US in 2006.

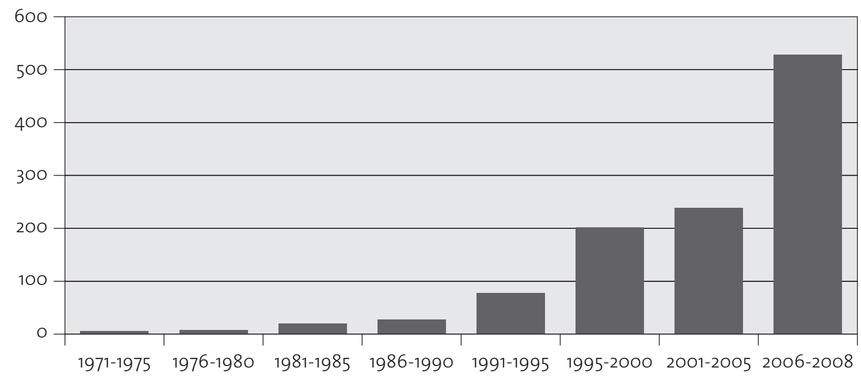
With regard to other long-term changes in the country composition of inward FDI, among developed countries there is a notable shift of interest of foreign investors away from resource-rich countries such as Canada and Australia to the leading industrial countries, especially the US and Europe. The main exception in this regard is Japan, whose share in total FDI stock has remained over the past two decades at the low level of below one per cent. Within developing countries there has been a long-term relative shift away from Africa and Latin America to Asia – especially South, East and South-East Asia.

6.3 Host developing countries: the shift towards Asia

The rapid growth of international production has not bypassed developing countries. FDI inflows into developing countries as a group have consistently increased in each of the five year periods during 1970-2005, accelerating during the 1990s and remaining at an elevated annual level of US$210 billion during 2001-2005 (figure 9). During the past 2.5 decades, the growth of FDI inflows into developing countries has kept pace with the growth of overall world inflows: the share of developing countries in world inflows was 28 per cent during 1981-1990 and 27 per cent during 1990-2000, declining slightly to one quarter during 2001-2005. On an annual basis this share has fluctuated around 30 per cent from 1970 to 2005 falling to 15-18 per cent during low years (1980, 1989 and 2000) and going up to 40 per cent in peak years (1994, see figure 10).

Figure 9

The growth of FDI inflows into developing countries, 1971-2008 (percentage)



Source: UNCTAD, FDI/TNC database.

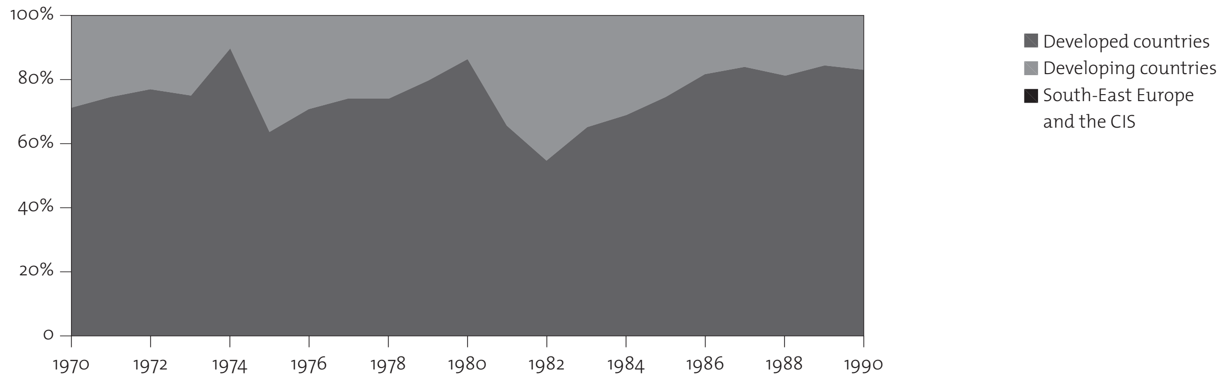
FDI inflows to all regions of developing countries have increased, but at different rates, resulting in relative changes in positions of the regions and key host developing countries. During the 1970s, until 1980, Latin America was by far the largest host developing region (figure 11) and Brazil the largest host developing country, attracting, for example, 35 per cent of total flows into developing countries in 1976 (UNCTAD, 2000a: 98), more than China, which is currently the largest host developing country, attracting 24 per cent in 2004 and 18 per cent in 2006.

During the decades that followed, Asia became the largest host region among developing countries, and in the 1990s, China became and remains the largest host developing country. During the 1980s almost all developing countries opened up to FDI at an accelerated pace. This gained momentum during the 1990s, but for many countries in Latin America, including Brazil, the 1980s are considered the "lost decade", characterized by the debt crisis, low growth, macroeconomic instability and a deteriorating investment climate which was not suitable to attracting increased FDI. At the same time many Asian countries experienced healthy economic growth, and some of them went through a period of excellent economic performance dubbed as the "East Asian economic miracle".

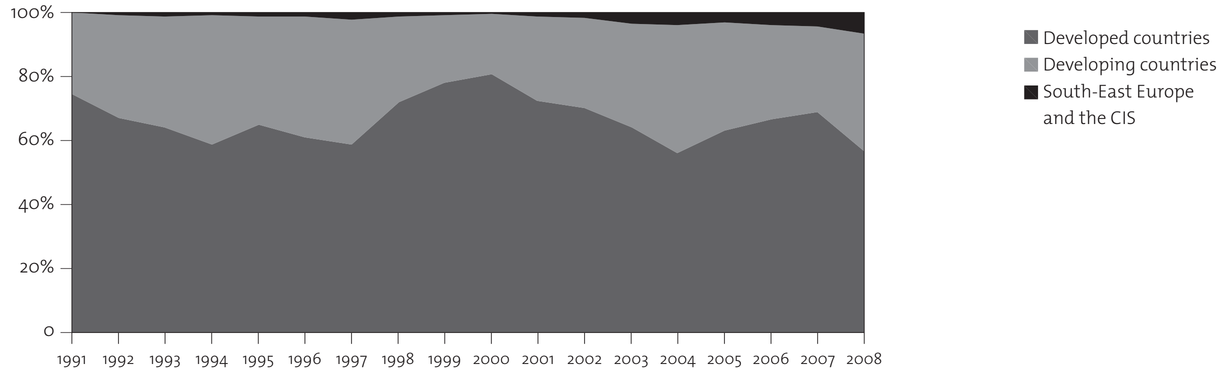
Figure 10

The fluctuating share of developing countries in global FDI (percentage)

10a | The share of developing countries in world FDI inflows, 1970-1990



10b | The share of developing countries in world FDI inflows, 1991-2008



Source: UNCTAD, FDI/TNC database.

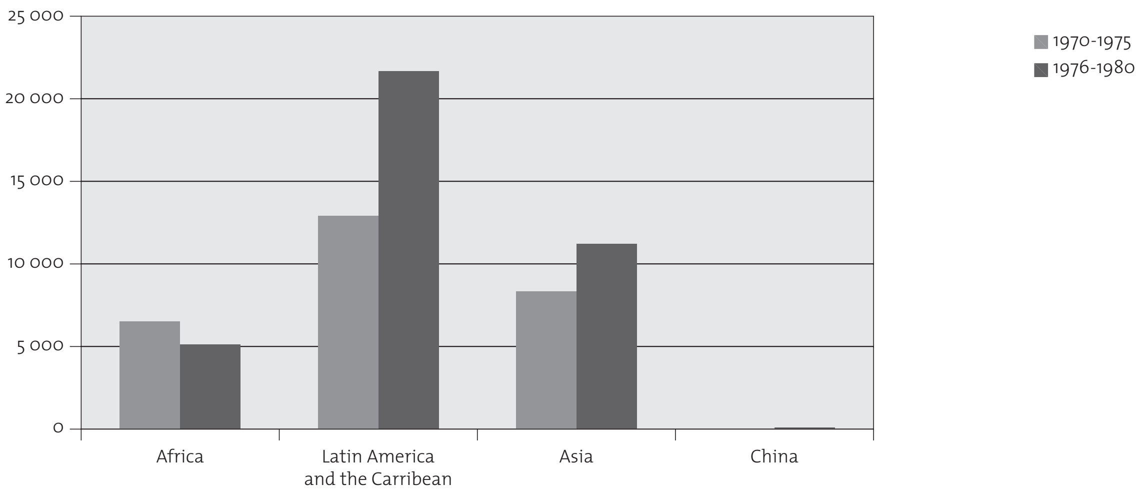
During the 1990s, Latin America restored macroeconomic stability and economic growth, once again attracting increased FDI inflows, stimulated by large privatization programmes, opening up service industries such as telecommunications, banking, electricity and water to FDI. Although Asia did not open its service industries to FDI as much as Latin America did, it also attracted increased FDI inflows particularly due to China. If China was excluded from Asia, Latin America as a whole would again be the largest host region among developing countries in terms of inflows (figure 11). During 1971-1975, Asia and Africa received almost the same amount of FDI flow in their region. Since that time, however, Africa's inflows have not been increased to the same extent as in the other two developing regions, although they have consistently grown in absolute terms.

Figure 11

Changing positions of developing country regions in FDI inflows, 1970-2008 (millions of US dollars)

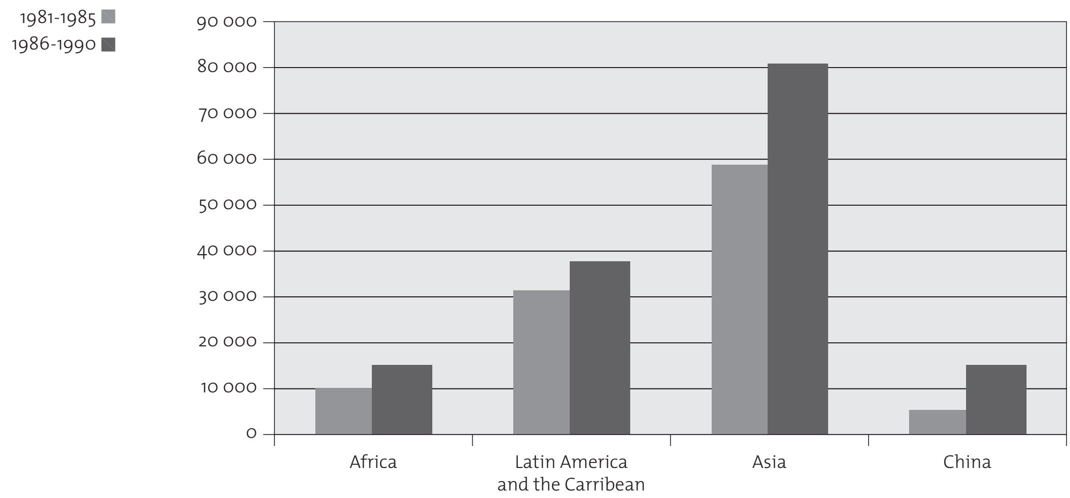
Until 1980 Latin America is the largest host region. China is closed to FDI.

11a | Cumulative FDI inflows by region, 1970-1975 and 1976-1980



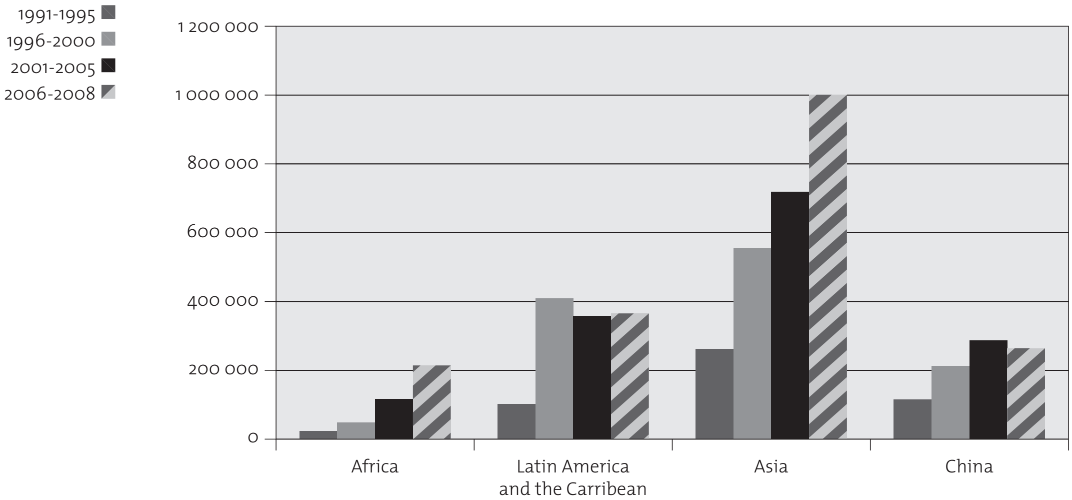
During the 1980s, Latin America loses its leading position to Asia. China emerges as a host country to FDI.

11b | Cumulative FDI inflows by region, 1981-1985 and 1986-1990



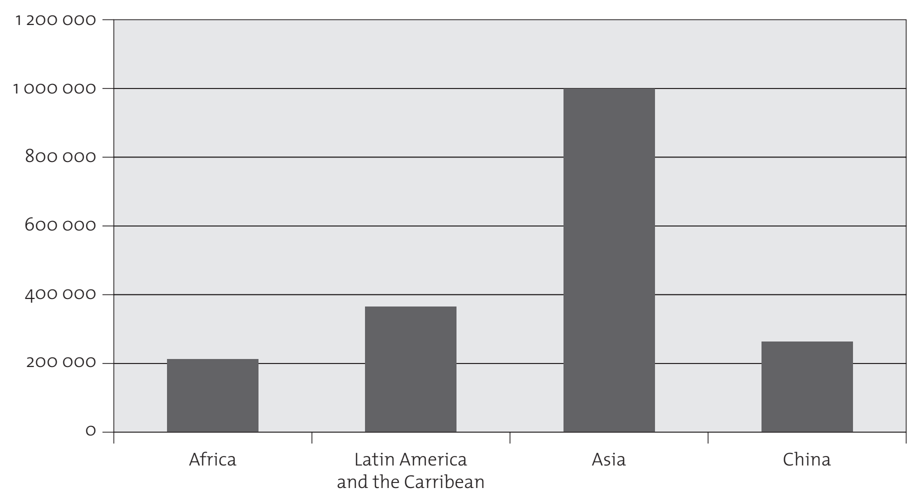
During the 1990s, FDI inflows into Latin America recover and grow fast but Asia remains the largest host region. China becomes a large recipient of FDI.

11c | Cumulative FDI inflows by region, 1991-1995, 1996-2000, 2001-2005 and 2006-2008



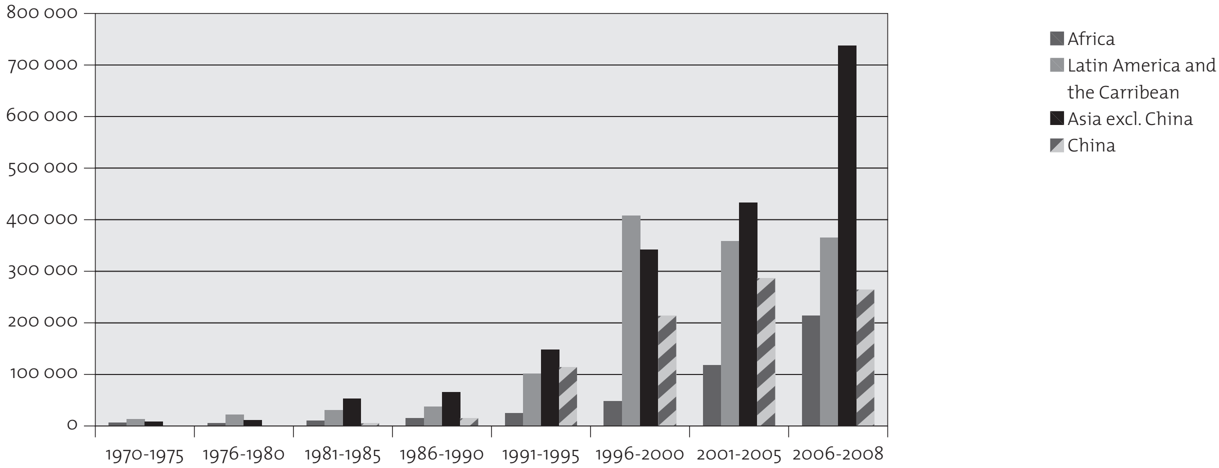
At the beginning of the 21st century China is among the largest host countries in the world and Asia is the largest host among developing regions. In spite of the growing inflows, Africa continues to lag behind both Asia and Latin America.

11d | Cumulative FDI inflows by region, 2001-2008



If China is excluded from Asia, the picture is different. Latin America receives smaller FDI inflows than Asia during the 1980s and from 1991-1995, but passes Asia (excluding China) from 1996-2008.

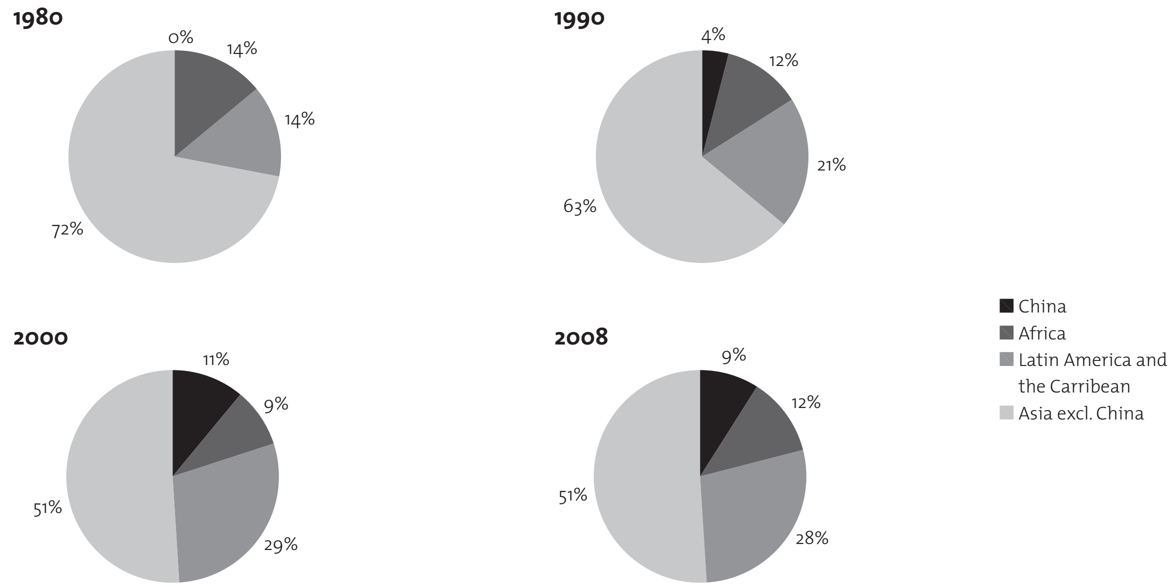
11e | Cumulative FDI inflows by region, 1970-2008



Source: UNCTAD, FDI/TNC database.

Figure 12

Changing positions in the inward FDI stock of developing countries, 1980, 1990, 2000 and 2008 (percentage)



Source: UNCTAD, FDI/TNC database.

Figure 12 shows the changes in relative positions of the three developing-country regions in terms of FDI stock from 1980 to 2008. In 1980, the distribution of FDI stock among them was quite balanced, with Africa and Latin America, accounting for 29 per cent and 25 per cent respectively of the stock of developing countries and Asia (with China) for the remaining 46 per cent. While Latin America increased its share over the following decades, until 2008, Africa's share declined to 12 per cent, while that of Asia increased to 60 per cent (including China's share of 9 per cent) by 2006.

7 The transnationality index of countries

In general, there has been a long-term trend towards a more even geographical distribution of inward FDI, with most countries of the world receiving increased volumes of FDI. In spite of this trend, inward FDI remains highly concentrated within groups of countries. The five largest host developed countries account for 70 per cent of inward stock of developed countries, while among developing countries the top five host countries account for 60 per cent and the top ten for over

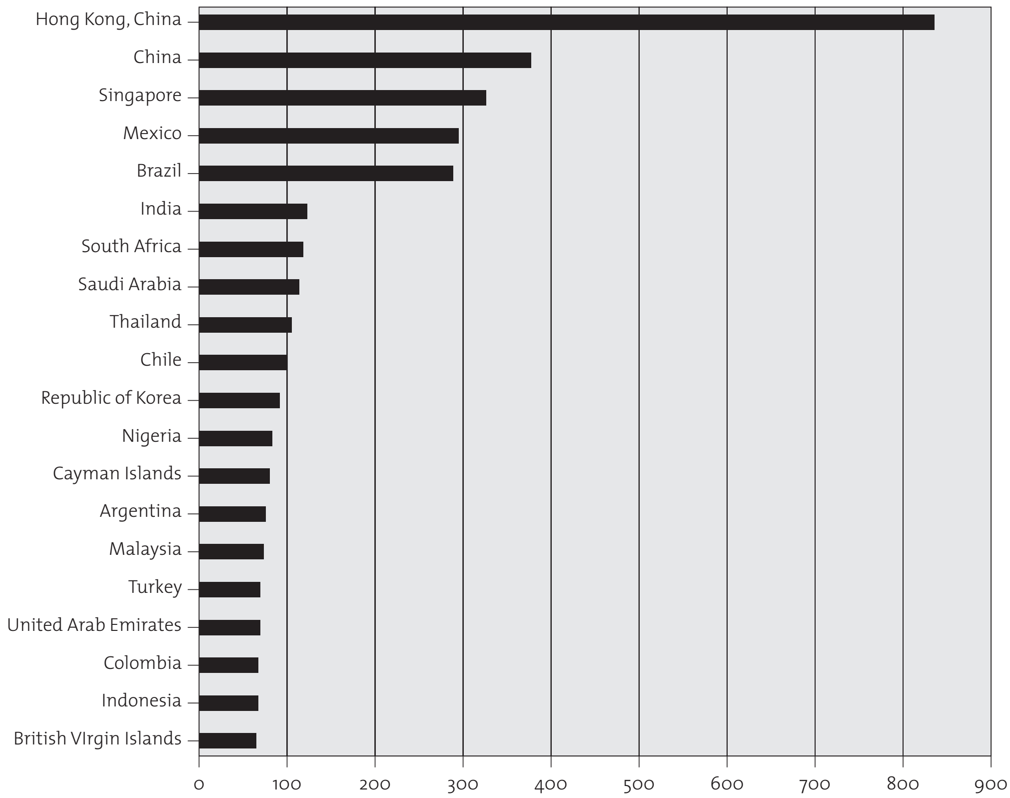
70 per cent of the group's inward stock. The concentration ratio for inward flows is similar. For example, the ten largest host developing countries accounted consistently for between 70 and 80 per cent of total FDI inflows to developing countries between 1990 and 2001 (UNCTAD, 2002: 11).

These ratios are often used to justify the claim that the overwhelming majority of countries, especially developing ones, are marginalized in international production and partly on that account, do not benefit from globalization. While this claim is largely correct, the FDI concentration ratios do not provide a correct picture, as they do not take into account differences in the relative sizes of the economies. After all, what matters for host countries is the relative role of FDI in their economic activities in terms of its contribution to investment, employment, value added, etc. The UNCTAD transnationality index of host countries tries to measure this role. It represents the average of four shares: a) FDI inflows as a share of gross fixed capital formation; b) FDI inward stock as a share of GDP; c) value added of foreign affiliates as a percentage of GDP; and d) employment in foreign affiliates as a percentage of total employment. The ranking of countries by this index differs considerably from that based on countries' size of (and shares in) inward FDI stock (figure 13), indicating that a group of smaller countries, which never make it to the group of top FDI recipients, are much more involved in international production through FDI relative to their economic size than the largest host countries.

Out of the ten largest host developing countries only three small countries – Hong Kong (China), Singapore and Chile are also on the list of top ten countries by the transnationality index. The overlap among the top twenty is greater: 11 countries are on both lists. But large host countries such as Mexico and Brazil are in the lower part of the transnationality ranking. International production networks account for a relatively large amount of the economic activity of several small developing countries including Trinidad and Tobago, Ecuador, Jamaica, Panama, Honduras, Costa Rica, Bahamas, the Dominican Republic and Peru; more than for China, the largest developing country recipient of FDI, which occupies 26th position on the transnationality list of developing countries, with an index of 8 per cent (UNCTAD, 2007: 13).

Figure 13

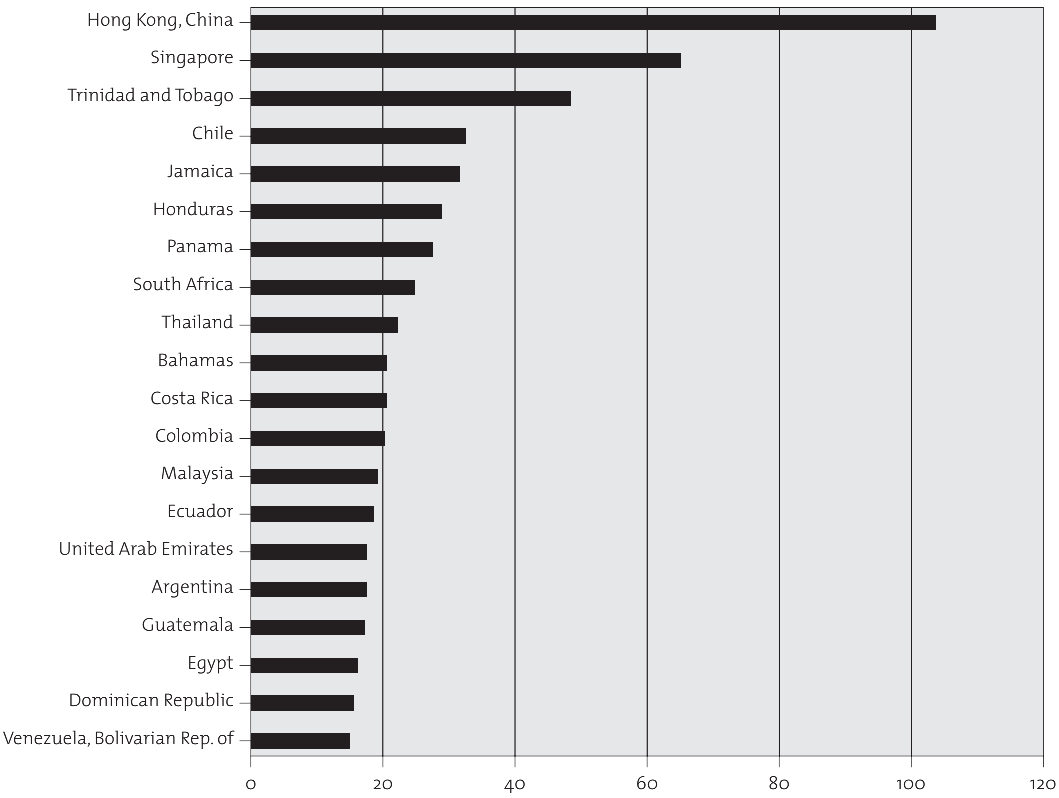
The 20 largest host developing countries ranked by the size of FDI stock, 2008 (billions of US dollars)



Source: UNCTAD, FDI/TNC database.

Figure 14

The 20 largest host developing countries ranked by UNCTAD transnationality index 2008



Source: UNCTAD, FDI/TNC database.

The differences between the two lists are even bigger in the case of developed countries (UNCTAD, 2003b: 6, 257). Only one country, the Netherlands, is on both lists, while the top positions on the transnationality lists are taken by other small EU countries: Belgium and Luxembourg, Ireland, Denmark and Sweden, followed by New Zealand and Canada, none of which belong to the group of the largest host developed countries. The US, the largest host country in the world, is 19th among developed countries and 49th among all countries ranked by the transnationality index (not all countries of the world are included – only those for which the four indicators are available). Thus, although it is true that many countries, especially developing ones, are only marginally involved in international production, based on the transnationality index, their list is much shorter than FDI concentration ratios indicate.

8 Conclusion

This chapter has focused on long-term trends in the internationalization of production. It concludes that international production has grown fast in recent decades – both in absolute terms and those relative to global investment, production and international trade. While FDI is the better-known aspect of international production, there has been an explosive growth in non-equity relationships between firms of different countries. Likewise, while manufacturing remains at the heart of international production, the internationalization of services has been on a rapid growth trajectory and services are now the largest sector in FDI. FDI in the primary sector has rebounded and will continue to rise in the coming years.

Developed countries are affected by the bulk of TNC activities (effects of outward and inward FDI) with 90 per cent of the world FDI stock originating from these countries and some 70 per cent located in the developed world. However, this should not distract from the fact that the activities of TNCs are fairly important for developing countries too. In fact, the weight of such corporations relative to the size of the economy is often bigger in developing countries than in developed countries. Among host developing countries, FDI is also concentrated in a few of them in terms of the size of stocks or flows, but only a number of smaller developing countries received large amounts of FDI relative to the size of their economies.

Still, one of the greatest challenges of globalization, and its unfulfilled promise, is a more equitable distribution of benefits from international production, especially in favour of the poorer developing countries. Continued marginalization of many of these countries in the global economy is one of the reasons why globalization is questioned in many quarters. This raises many policy issues related to international production. One is policy competition to attract FDI, which often puts developing countries at a disadvantage *vis-à-vis* advanced countries and also distorts allocation of resources among and within advanced countries. Another is the issue of policy space needed in particular in developing countries to pursue their development objectives and to increase benefits from FDI. This question, concerning formulating international investment policies in ways that are not harmful, but also beneficial to developing countries, will be addressed later on, while discussing international investment agreements.

Exercises and questions for discussion

1. What is international production? What are its key forms and how it is measured? What are the problems with measuring international production?
2. Characterize the increasing importance of international production in the world economy. In which areas is it greater and in which is it lower?
3. How does FDI behave during economic recessions and slowdowns?
4. Why are cross-border M&As considered sometimes a less desirable mode of FDI entry into host countries?
5. Characterize non-equity forms of TNC participation, industries in which they are common and new trends. What are the reasons for growth of non-equity forms of international production?
6. Characterize the growing role of services in world FDI: the growing share, industries and key reasons.
7. Characterize key differences between the geographic pattern of world inward and outward FDI 30-40 years ago and now.
8. Characterize key long-term trends in FDI in developing countries.
9. What does it mean in the area of FDI that developing countries are marginalized in the global economy?

10. **Practical exercise**

    Collect data on FDI in your own country and follow the pattern of the theme to prepare a short paper on long term trends in FDI in your country as well as on the changing position of your country in the regional or world FDI. The paper, depending on the availability of the date should address the following questions:

    Questions:
    - Characterize very briefly the attitude of your country towards FDI.
    - What are long-term trends in inward FDI stocks and flows?
    - What is the industry and secotral composition of inward FDI?
    - What are key home countries for FDI in your country?
    - Is the role of FDI in the economy of your country growing? If so, which areas and industries?
    - Does your country have outward FDI? If so, what are flows and stocks? In which countries and industries?
    - How is the role of FDI in your country perceived? Does your country receive sufficient amounts of FDI? What are perceptions of the role of FDI in the development of your country?

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Theme 3
Determinants of Foreign Direct Investment

INTRODUCTION

To explain the differences in FDI between and within countries, it is necessary to understand why and when firms invest abroad and how they make choices among investment locations. Even though many specific determinants can be identified, different for each investor, they can be grouped into three broad factors underlying the decision of a firm to engage in FDI: the presence of **ownership-specific competitive advantages** on the part of the firm, the presence of **location-specific advantages** in one or more foreign countries; and the presence of **internalization advantages** – that is, benefits for the firm in exploiting its competitive advantages internally rather than through transactions with other firms. Countries with large numbers of firms that have the necessary competitive advantages and benefits from internalization are likely to generate more outward FDI than others, and countries with greater location advantages for TNC activities, are likely to attract more inward FDI than others.

For countries seeking to attract FDI, understanding the country-specific factors that determine the choice between different locations is particularly important. These host-country determinants include three sets of factors: **economic factors**; the **policy framework for FDI**; and **business facilitation measures**. The possible interactions between these determinants must be kept in mind, as well as the fact that their relative importance may change over time, as the economic environment changes. The relative importance of various location-specific FDI determinants depends on the motive for, and type of investment as well as the industry in question. Moreover, the same motivation can lead to different location choices depending on the foreign investors' strategies. Such strategies are becoming increasingly complex nowadays and require specific combinations of determinants for a country to be successful in attracting investors in today's highly competitive market for FDI.

At the end of this theme, students should be able to:

- Understand the key conditions and motivations that impel firms to undertake FDI;
- Understand the firm-specific determinants of FDI;
- Understand and analyze the main types of location-specific (host-country) determinants of FDI as well as their evolution;
- Understand and analyze the role of various economic factors as host-country determinants of FDI and their interaction with TNC motivations and strategies;
- Understand and analyze the role of national policies as host-country determinants;
- Understand the influence of international policy frameworks on host-country determinants; and
- Understand and analyze the role of business facilitation measures, including investment promotion and other pro-active facilitation measures, as host-country determinants of FDI.

HANDBOOK

1 Key factors determining FDI

A widely used theory to explain FDI argues that FDI takes place when three sets of determining factors exist simultaneously. As summarized in the OLI paradigm (box 13), these are:

- The **presence of ownership-specific** or **firm-specific competitive advantages** *vis-à-vis* local firms that can compensate for the additional costs of establishing production facilities in a foreign environment and help firms overcome their disadvantages *vis-à-vis* local firms in foreign countries.

- The **presence of location advantages**, or country-specific advantages that firms can combine with their firm-specific competitive advantages by establishing production facilities in foreign countries.

- The **presence of superior commercial benefits** for firms resulting from the exploitation of ownership-specific and location-specific advantages by investing in foreign affiliates that they control, rather than through transactions with unrelated firms located abroad.

While the first and third conditions are firm-specific determinants of FDI, the second is host country-specific and has a crucial influence on a country's inflows of FDI.

If only the first condition is met, firms will rely on exports, licensing or the sale of patents to service foreign markets. If the third condition is added to the first, FDI becomes the preferred mode of servicing foreign markets, but only in the presence of location-specific advantages.

The degree to which an individual firm responds to a particular configuration of firm-specific and location-specific advantages for FDI depends on the extent to which it considers international production to be consistent with its long-term objectives and management strategy. In general, however, the propensity of the enterprises of a particular country to engage in outward FDI or international production depends on the extent to which those enterprises possess ownership-specific advantages, the extent to which they find it preferable to internalize rather than externalize their use, and the more they find it in their interest to exploit them from one or more foreign locations. A country's ability to attract FDI depends on the location advantages it offers TNCs in light of their motivations and strategies.

The focus on the three sets of factors, mentioned above, as determinants of FDI reflects developments in the theory of international production by TNCs – or international economic involvement through FDI that have taken place during the past four decades or so. Before that, international economics mainly consisted of a well-developed formal theory of international trade and a less well-developed theory of capital movements (Dunning, 1993b: 183), with FDI considered one kind of capital movement. As FDI grew in importance and greater attention was given to its nature, existing explanations were found inadequate for two reasons: first, FDI involves the transfer of resources (such as technology and management know-how) other than capital and it is the expected return on the entire package, rather than on the capital per se, that prompts firms to become TNCs. Second, in the case of FDI, resources are transferred internally within the firm rather than externally between two independent parties: the investor or TNC retains control over their usage, and without such control, the resources may not have been transferred. Thus any theory of FDI needs to explain the conditions under which firms engage in value added activities abroad, addressing both the location of value added activities and the ownership and organization of those activities. While different scholars have looked at these issues from different perspectives, e.g. industrial organization and market structure, macroeconomics and trade, technology and product cycles, market failure and transaction costs, the OLI paradigm provides a general framework that draws together the main lines of explanation for FDI and TNC activity that have emerged in the literature (Dunning, 1993a: chapter 4).

Location-specific determinants are the only ones that governments can influence directly. The discussion that follows focuses mainly on this set of determinants, which are the most relevant from the point of view of countries seeking to attract and benefit from inward FDI, including in the context of IIAs. First, however, it briefly takes a closer look at the nature of firm-specific competitive advantages, which enable firms to extend their production activities to foreign locations, and internalization advantages, which give them the incentive to do so.

Box 13

The OLI paradigm

The OLI paradigm (Dunning, 1993a), also known as the eclectic paradigm, addresses three questions related to FDI:

Which firms undertake FDI? Firms investing abroad must possess proprietary or **ownership-specific ("O") advantages** to overcome the extra costs of operating in a different, less familiar environment. These advantages are generally costly to create, but can be transferred to new locations at relatively low cost. The analysis of "O" advantages draws on industrial organization, resource-based, evolutionary and management theories, with advantages residing mainly in firm-specific technology, brand names, privileged access to factor or product markets or superior technological or management skills. Initial "O" advantages allow firms to grow and invest abroad, but size and international spread can, in turn, feed back and provide new advantages (accessing capital markets and information, spreading risks and so on). In some cases, firms may go overseas to supplement or enhance their existing "O" assets, seeking synergies between their own strengths and those of foreign firms or institutions.

Where do firms choose to exploit their advantages, in the home country (by exports) or abroad, and in which foreign locations? They select sites with **location ("L") advantages** that best match the deployment of their "O" assets. The analysis of "L" advantages draws on trade and location theory, the main factors determining location being factor and transport costs, market size and characteristics, and government policies (e.g. stability, predictability, tariffs, taxes and FDI regulations).

Why do firms choose to internalize their advantages by direct investment in preference to selling them (or output based on them) to other firms? The analysis of **internalization ("I")** draws on transaction-cost theories of the firm. It centers on the feasibility of, and returns to, production by firms based on their ownership advantages, as compared with those from contracting the sale of those advantages to other firms, including foreign ones. The most valuable and new advantages tend to be internalized, since these are the most difficult to price and contract over time (they involve important transaction costs). The more mature ones are easier to price, less subject to uncertainty and less valuable to the owner: these are licensed more readily. Internalization can also explain vertical FDI, where a particular process or function is located abroad by TNCs to serve its production system (rather than subcontracted to independent suppliers). Transaction cost analysis can also help explain why it is difficult or costly to contract independent firms for such arrangements, particularly in technology-intensive or strategic activities.

Source: UNCTAD (2000: 141).

2 Firm-specific determinants of FDI

As noted (box 13) firm-specific or ownership-specific competitive advantages are necessary if firms are to undertake FDI and become transnational companies. This is because in any particular market, domestic firms have an intrinsic advantage over foreign firms – they have better local connections and a better understanding of the local business environment, the nature of the market, business customs, legislation and the like. Consequently, foreign firms wishing to produce in that market have to possess some kind of advantage to offset the advantage held by domestic firms.

Such competitive advantages may arise from proprietary assets such as technology and managerial and marketing expertise developed by individual firms, or privileged access to markets or factors of production. They may also arise from firm size, economies of scale and market power. Once firms establish operations abroad on the basis of such advantages, their control of productive assets abroad and their networks of international production can become further sources of competitive advantage.

However, the possession of such advantages is not sufficient for firms to engage in FDI, even if foreign countries possess location advantages that can be profitably combined with firms' ownership of specific assets. FDI will occur only if there are greater benefits in exploiting these advantages internally within firms, by extending production under their control to foreign locations, than in arm's length transactions in markets for inputs (including technology, knowledge and management expertise) or output.

Benefits from internalization can arise if the markets for production inputs are imperfect and involve significant transaction costs or time lags.

This is especially likely to be the case for intangible knowledge-based assets such as technology; particularly that related to new products and processes. Uncertainty over the availability, price or quality of supplies or of the price of a firm's product is a major incentive for internalization. A firm may also prefer to retain exclusive right to, or control of, "core assets", especially a new technology or a brand name, which confer on it a significant competitive advantage resulting in higher profits or monopoly rents.

Although ownership-specific and internalization advantages are endogenous to individual firms, the fact that they are seen to differ according to nationality of enterprises suggests that they are not independent of the industrial structure or of the economic systems and of the institutional and cultural environment of which they are part (Dunning 1993b: 206). For example, the technological lead on the basis of which firms from some countries enjoy competitive advantages in several industries and engage in FDI is related to those countries' factor endowments, income levels and market needs, government policies with respect to innovation, and so on.

The country or industry variables affecting firm-specific advantages in a country may also be related to the location-specific advantages that attract FDI to the country (discussed below), but the two sets of factors are not the same. It has been suggested, moreover, that as a country develops, the configuration of the OLI advantages facing foreign firms that might invest in the country, and of its own firms that might invest abroad, changes (Dunning, 1993a: 88-89). According to the concept of the "investment development path", countries move from a situation of insufficient ownership-specific advantages as well as (insufficient) location advantages – and hence no inward or outward FDI – to one where sufficient location advantages are built up to attract inward FDI and finally, sufficient ownership-specific advantages for their own firms to engage in outward FDI. Eventually, as and when countries reach some degree of economic maturity, the OLI configuration facing their own firms may be such that the propensity to engage in outward direct investment exceeds that of foreign-based firms to engage in inward investment in countries.

3 Host-country determinants of FDI

As noted, the presence of location-specific advantages in one or more host countries is essential for FDI to take place. In turn, differences in location advantages between countries explain differences in FDI inflows among countries. A variety of factors determine a country's ability to attract FDI. These host country determinants may be divided into three broad groups: economic factors; the policy framework; and business facilitation (annex, table A.1). The key determinants in each group are reviewed further below.

Several considerations should be noted before reviewing the host-country determinants of FDI (UNCTAD, 1998: 90):

- **Direct investment abroad is a complex venture**. It involves a long-term commitment to a business endeavor in a foreign country and often the engagement of considerable assets and resources that need to be coordinated and managed across countries and to satisfy the requirements of successful investment, such as sustainable profitability and an acceptable risk/profitability ratio. Typically, there are many host-country factors involved in deciding where an FDI project should be located and it is often difficult to pinpoint the most important factor. Moreover, although the analysis that follows treats each of the three sets of determinants separately, the interrelationships among them must be borne in mind.

- **The relative importance of different location-specific determinants can vary**, depending not only on the motive for investment (e.g. resource-seeking or market-seeking) and the sector of investment (e.g. services or manufacturing) but also on whether the investment is new or sequential, the mode of entry (greenfield or M&As) and the size of the investors (small and medium-sized TNCs or large TNCs).

- **The relative importance of different determinants also changes as the economic environment evolves over time**. It is therefore entirely possible that a set of host country determinants that explains FDI in a particular country at a given time change as the structures of its domestic economy and of the international economy evolve. At the same time, there are some location-specific determinants that remain constant.

As a general principle, host countries that offer what TNCs seek, and those with policies that are most conducive to TNC activity are likely to attract the most FDI. But firms also see location determinants in their interaction with ownership-specific and internalization advantages in the broader context of their corporate strategies.

These strategies aim, for example, at spreading or reducing risks, pursuing oligopolistic competition or matching competitors' actions. In the context of different strategies, the same motive and the corresponding host country determinants can acquire different meanings. For example, the market-seeking motive can translate, in the case of one TNC, into the need to enter new markets to increase the benefits arising from multi-plant operations; in the case of another TNC, it can translate into the desire to acquire market power; and for a third TNC, it can aim at diversifying markets as part of a risk reducing strategy. Thus, in trying to identify factors conducive to attracting FDI, it is important to understand not only the motives of potential investors but also their strategies.

3.1 Economic determinants

Location-specific economic factors in host countries are fundamental when TNCs make decisions regarding where to invest abroad. The importance of different host-country economic determinants varies, however, according to TNC motivations and strategies related to FDI.

The overall motivation underlying FDI is to improve or sustain the profit position of the firm undertaking it. Pursuing the profit motive can have many variations: long or short term; stability or growth; spreading or reducing risk; profit of the TNC as a whole or profit of individual units. In pursuing this overall objective, TNCs may have different motives with regard to what they seek in host countries. Broadly speaking, four types of FDI may be identified, according to TNC motivation for investing in foreign countries: **resource-seeking, market-seeking, efficiency-seeking, and strategic asset-seeking**. Thus, host-country economic determinants can be grouped for analytical convenience into four clusters, each including the key factors determining FDI of each of the types mentioned above (annex, table 5). The discussion below focuses on the key determinants in each cluster.

3.2.1 Natural resources

Historically, the most important host-country determinant of FDI was the availability of resources – specifically, natural resources (UNCTAD, 1998: 106). In the nineteenth century, much of the FDI by European, US and Japanese firms was prompted by the need to secure an economic and reliable source of minerals and other primary products for the growth of industries in the home countries. Up to the eve of World War II, about 60 per cent of the world FDI stock was in natural resources. Since then and particularly since the mid-1970s, however, the relative importance of natural resources as a host-country determinant has decreased considerably. The decline in the importance of natural resources as an FDI determinant can be attributed to a decline in the importance of the primary sector in world output, and to the emergence of large indigenous enterprises or joint ventures in many developing countries, usually State-owned, with sufficient capital and technical skills for the production and distribution of raw or processed products to customers worldwide. Recently, however, as a result of rising mineral prices, the share of extractive industries in global FDI has increased, although it is still much lower than those of services and manufacturing (UNCTAD, 2007a: xxi).

Though declining in relative importance, the availability of natural resources continues to offer important possibilities for inward investment in resource-rich countries. Raw materials, mainly minerals, still explain much of the inward FDI in a number of countries, developing (e.g. countries in sub-Saharan Africa), developed (e.g. Australia) and countries in transition (Azerbaijan, Kazakhstan and Russian Federation). Natural resources are the basis of tourism that attracts FDI to some small countries, for example, some Caribbean island developing countries. However, as the number of countries with natural-resource endowments that are accessible to FDI has increased over time (due to increased awareness of countries' endowments, lower transportation costs, and more liberal inward FDI policies), not only availability but costs of production related to natural resources, and physical infrastructure related to production and distribution have also become important as host-country determinants of resource-seeking FDI.

3.2.2 Markets

Another important group of economic determinants of inward FDI corresponds to the motivation of firms, including TNCs, to grow and/or to stay competitive by gaining access to new markets at home and abroad and/or increasing their shares in existing markets. The relevant determinants of market-seeking FDI to a country include market size – in terms of the absolute size of a market as well as in relation to the population, as measured by total and per capita income, respectively – and market growth. Large markets can accommodate more firms and can help firms to achieve scale and scope economies. A high rate of market growth tends to stimulate investment by both domestic and foreign producers, since both are interested in returns to long-term projects.

Traditionally, market size and growth as FDI determinants have related to national markets. A major reason was that in most countries domestic markets for manufacturing products were sheltered from international competition by high tariffs or quotas that triggered "tariff-jumping FDI". Overcoming these obstacles to market access was the predominant motive for FDI in the manufacturing sectors of developed countries between the two world wars and of developing countries in the 1960s and 1970s, during the heyday of import-substitution industrialization strategies. Japanese FDI in the automobile industry in the US in the 1980s was also motivated by similar considerations, following voluntary export restrictions and the possibility of further protectionist measures in the automobile industry. The size and growth of national markets were (and still are), also important locational determinants of FDI in services, because most services are not tradable and the only way to deliver them to foreign markets is through establishment of affiliates close to the customers. Although restrictive FDI frameworks limited the size of FDI in services in developed as well as developing countries well into the 1980s, market-seeking FDI in a variety of services has grown rapidly since then.

The opening of markets to trade, FDI and technology flows in recent years has created enlarged markets for final and intermediate goods and some (tradable) services, and provided TNCs (and domestic firms) with better access not only to national, regional and global markets for those products but also to markets for factors of production and other resources. This has enlarged the range of choices open to firms regarding the modalities of serving these markets, including especially by FDI (involving equity ownership), trade, licensing, subcontracting and franchising; provided them greater access to immobile resources (e.g. unskilled labour, low-cost skilled labour and created assets) in host countries; and created scope for improving the efficiency of their international production systems.

These changes and expanded choices for TNCs mean that large and growing national markets no longer play as important a role as in the past as host-country determinants of FDI in goods and tradable services. Many national markets can be served from elsewhere and it is efficiency rather than local presence that matters for firms seeking to expand markets for their products. At the same time, access to large markets, including regional markets – because of geographic location or membership in a regional trade agreement, for example – can be a factor that, along with other, efficiency-related determinants (discussed below), attracts FDI to a particular country. Moreover, national markets continue to be important host-country determinants in the case of most services because of their non-tradability, and in the case of manufactured goods where proximity to buyers is an advantage due to factors such as high transport costs, the need for adapting to local tastes and preferences, or the need for responding rapidly to changing demand conditions.

3.1.3 Efficiency-related factors

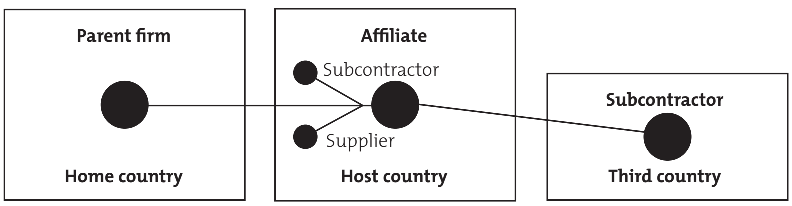
A third and increasingly important group of host-country economic determinants of FDI are those sought by TNCs engaged in efficiency-seeking FDI. The motivation behind efficiency-seeking FDI is to rationalize the international production structure of a TNC by taking advantage of differences in the availability and costs of factors of production and in other conditions related to production and markets in different countries, and thereby improve the efficiency of the TNC as a whole, reaping benefits from geographic specialization in production and economies of scale and scope.

Unlike market-seeking TNCs, which pursue stand alone (or multi-domestic) strategies with regard to the structure of their international production, with each foreign affiliate linked just to the parent firm (for managerial control and firm-specific technology or other know-how), TNCs motivated by efficiency considerations engage in vertical integration of their production processes through simple or complex integration strategies.

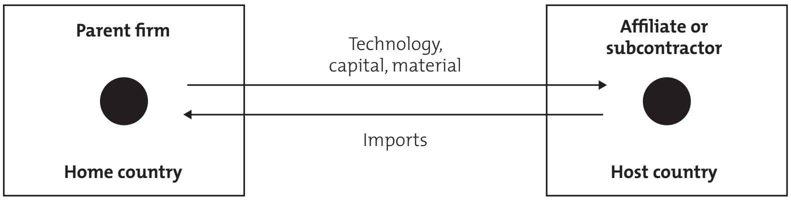
Figure 15

Strategies and structures of TNCs

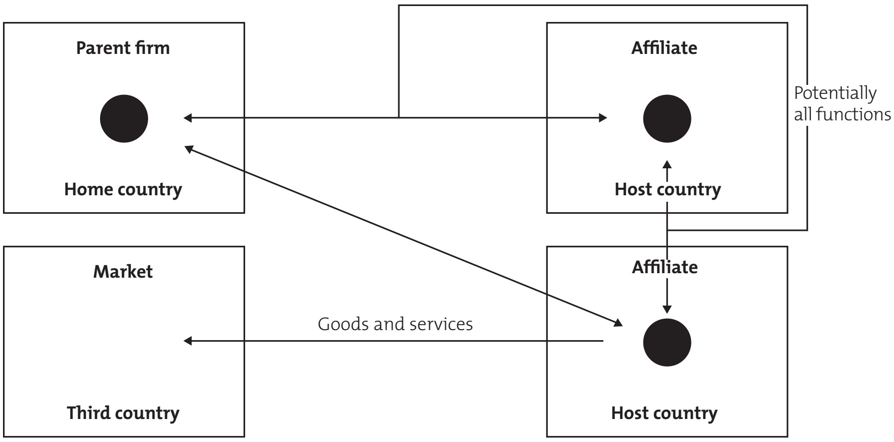
15a | Stand alone integration: multi-domestic



15b | Simple integration: outsourcing



15c | Complex integration



Source: UNCTAD (1993).

Simple integration involves a limited number of links within TNC systems between production units in different locations, while complex integration strategies involve splitting the value chain into specific activities or functions and performing each of them in the most cost-effective location from the viewpoint of the corporate system as a whole. Efficiency-seeking TNCs may also engage, however, in horizontal integration of their production activities in their pursuit of firm-level economies of scale and scope: they may establish similar production activities (e.g. manufacture of different models of an automobile) in a selected number of locations and export the products regionally or globally. Such horizontal integration may also be combined with vertical integration.

In order for efficiency-seeking international production to take place, cross-border markets must obviously be well-developed and open. Trade liberalization and regional integration in recent decades have given an impetus to efficiency-seeking motives for FDI, which are increasingly intertwined with market-seeking and natural-resource seeking motives as well.

Host-country determinants of efficiency-seeking FDI include a variety of factors, one or more of which play an important role in attracting such FDI, depending on the activities and strategies of the TNCs concerned. Some of the key determinants are considered below.

3.1.4 Low-cost unskilled labour

This is an important determinant of FDI by TNCs seeking greater efficiency in producing labour-intensive products or products for which some stage of production, geographically separable from other stages, is intensive in the use of unskilled labour. This kind of FDI began to emerge as early as in the 1960s but began to flourish only under conditions of globalization, driven by improvements in transport and communication technologies and liberalization of trade, FDI and technology flows. Under such conditions, efficiency-seeking TNCs in industries where labour costs matter, facing increasing competitive pressures, pursue simple integration strategies, transferring labour-intensive products or processes in the value chain to foreign affiliates established in countries – typically developing countries or transition economies – with low-cost unskilled labour.

However, since the number of countries with an abundance of labour is not small, even though the principal resource sought is low-cost unskilled labour, host countries have to typically offer more. Typically, reliability of supply, labour productivity, infrastructure availability and costs, and access to international markets, particularly developed-country markets, are the economic considerations in determining the choice between labour-abundant host countries. In addition, FDI policies and business facilitation also matter.

3.1.5 Created assets

Created capabilities, competences, and production infrastructure are important locational determinants of efficiency-seeking FDI, especially by TNCs pursuing complex integration strategies. As TNCs try to sustain their competitiveness by splitting up the production process into various specific activities and locating those activities in countries best suited to each activity, they seek such assets and capabilities created through investments in people, knowledge and physical capital: human resources with a range of skills (e.g. computer literacy and programming skills), attitudes (e.g. attitudes to wealth creation and business), capabilities (e.g. technological and managerial capabilities), competencies (e.g. to organize income generating assets productively) and relationships (interpersonal or with governments); knowledge related to products and processes, R&D, design, advertising and distribution; and information.

The role of knowledge-based resources and assets in production has increased considerably in recent years. The availability of one or more of them at competitive prices has therefore become a key host-country determinant of FDI by firms seeking to remain competitive. In addition, since the ability to link specialized affiliates to one another and to the parent firm within TNC networks of geographically dispersed activities is essential for efficiency-seeking FDI, another group of created assets – infrastructure facilities, especially, reliable transport systems and high-quality telecommunication systems – are complementary host-country determinants of such FDI.

3.1.6 Agglomeration economies

TNCs seeking created assets in knowledge-intensive industries may gravitate to spatial clusters of related activities or specialized support services within a country or region. Such clusters provide benefits to firms present in those locations in the form of agglomeration economies or externalities (e.g. through exchange of uncodifiable knowledge, interactive learning and face-to-face discussions).

In the past, efficiency-seeking FDI usually occurred once resource-based or market-seeking investment became sufficiently numerous and important to warrant some kind of rationalization (Dunning, 1993a: 59). Increasingly, however, FDI by new entrants is also being undertaken as part of a carefully integrated international production strategy combined with a regional or global marketing strategy. As potentially all parts of the production process can be assigned to specialized foreign affiliates by TNCs that pursue complex integration strategies, the range of resources or assets sought in host countries is wide and cuts across the entire value chain. Locations that offer a wide range of resources and created assets can thus attract FDI in a variety of value-added activities.

3.1.7 Strategic assets

A fourth group of host-country determinants corresponds to strategic, asset-seeking FDI by TNCs motivated by the aim of adding to their existing portfolios of assets others that are expected to sustain or strengthen their own overall competitive position or weaken that of their competitors. The assets sought are usually those of foreign firms and are acquired through cross-border mergers and acquisitions. Unlike FDI by resource, market or efficiency seeking TNCs, strategic, asset seeking FDI is motivated less by the aim of exploiting specific competitive advantages the TNCs possess over their competitors than by that of adding to those advantages.

The host-country determinants of strategic asset-seeking FDI include firm-specific assets in host countries, such as technological and innovative assets and capabilities; marketing know-how or brand names. The availability of firms with such assets for cross-border mergers and acquisitions is thus a key host-country determinant of such FDI. In most strategic investments, the expectation is that the acquisition or joint venture in the host country will add to the competitive advantages of the rest of the organization of which it is part, by opening up new markets, creating R&D synergies or production economies, buying market power, lowering transaction costs, spreading administrative overheads, advancing strategic flexibility, and enabling risks to be better spread (Dunning, 1993a: 60). Strategic considerations and other motivations for FDI, especially efficiency considerations, often go together, however, so that the availability of competitive firms in host countries for M&As may attract TNCs with strategic as well as other motivations.

3.2 The role of policies as determinants of FDI

3.2.1 The national policy framework

While economic factors are fundamental, host-country policies play an important role as determinants of FDI in a country. This is best illustrated by the obvious fact that FDI cannot take place unless it is allowed to enter a country. On the other hand, even highly liberal and encouraging policies with respect to FDI cannot guarantee that a country attracts FDI in desired amounts if the economic factors sought by TNCs are absent, highlighting the limits of policy as a determinant.

National policies affecting inward FDI include core FDI policies or policies directly related to FDI, as well as a number of other policies that indirectly affect FDI. The former, (the "inner ring" of FDI policies), include rules and regulations governing the entry and operations of foreign investors, the standards of treatment accorded to them, and the protection of foreign investors. Policies related to market supervision and competition, although not specific to FDI, directly influence it and can hence be grouped along with core FDI policies. The same applies to investment promotion and other proactive measures to attract FDI (discussed below under business facilitation). Other policies that indirectly influence FDI (the "outer ring" of policies) include policies related to trade, privatization, taxation, macroeconomic stability and a number of other areas of an economy such as its macro-organizational aspects, labour markets, education, and the environment. Core FDI policies can have a strong and direct influence on FDI in a country, but the others can have important effects as well.

3.2.2 Core FDI policies and FDI location

Core FDI policies or policies directly dealing with FDI in a country include:

- Rules and regulations governing the entry of foreign investors and the establishment of operations by them in a host country including in particular prohibition or freedom of entry; restrictions on foreign ownership (joint venture requirement) or lack thereof.
- Standards of treatment accorded to foreign firms including non-discrimination in the treatment of foreign and domestic firms (before and after entry); preferential treatment of foreign or domestic firms (e.g. through incentives).
- Protection accorded to foreign investors including rules governing expropriation and nationalization; funds transfers; and dispute settlement.

Core FDI policies are typically intended to satisfy various objectives with respect to the FDI a country receives and include: reducing or increasing FDI; influencing its sectoral composition or geographic origin; encouraging specific contributions to the economy and affecting ways in which these contributions are made. It should be noted that while open and favourable policies with respect to the three elements listed above are central to attracting FDI (given host-country economic determinants), their overall effects depend to a considerable extent on the presence of market supervision to ensure a competitive market structure. Thus market supervision for maintaining competition can arguably be considered a further aspect of core FDI policies. Furthermore, as policies with respect to entry, establishment, standards of treatment and protection of FDI have become increasingly liberal, investment promotion and other measures to attract and facilitate FDI are assuming increasing importance. The latter are discussed separately in section 3.3.

Figure 16

The liberalization of FDI policies

Market distortions

Restrictions:
- Entry and establishment
- Ownership and control
- Operational restrictions
- Authorization and reporting

REDUCING

Incentives:
- Tax advantages
- Financial incentives
- Others

Standards of treatment

- National treatment
- Recourse to international means for the settlement of investment disputes

BUILDING

- Fair and equitable treatment
- Transfer of funds
- Transparency

Market supervision

- Competition policy (including, international M&As)
- Monopoly regulation
- Prudential supervision
- Disclosure of information

Source: UNCTAD (1998: 94).

Since the mid-1980s, liberalization of FDI policy frameworks (figure 16) has become the dominant type of FDI policy change (UNCTAD, 1998: 94-96). Countries, including developing countries have increasingly revised their national policies to reduce restrictions on FDI, strengthen positive standards of the treatment of foreign investors, and strengthen market supervision so as to improve the functioning of markets. Economies in transition have made a significant switch towards liberal frameworks. Dramatic increases in FDI flows to some transition economies in Eastern Europe and to China following liberalization reflect the importance of FDI policy as a locational determinant. In some other regions (e.g. Africa) and countries (e.g. some transition economies in CEE) liberalization has often had little effect on FDI inflows. This underlines the fact that open FDI policies and improved investment climate are a necessary but not sufficient host-country determinant of FDI and work only in the presence of host-country economic factors conducive to attracting FDI. In addition, one aspect of liberalization that did not develop in the expected direction was the issue of incentives. Liberalization should entail a reduction in the practice of different treatment of foreign companies in terms of granting or withholding incentives. For withholding incentives this might be true, but TNCs still enjoy preferential treatment in many instances (see section 3.3 below).

3.2.3 Recent developments of FDI-related policies

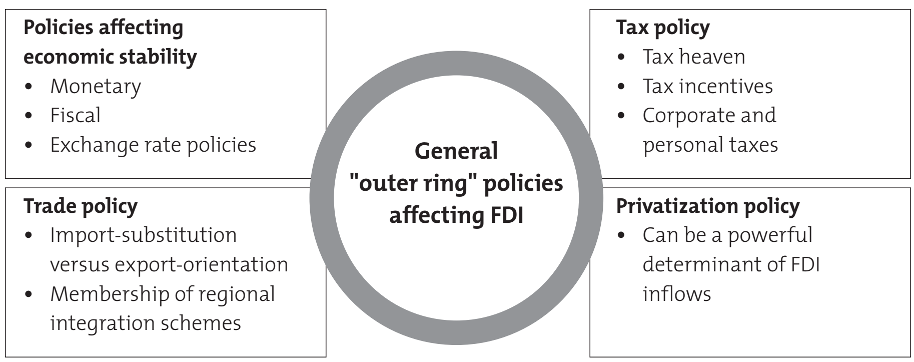
UNCTAD's 2008 survey of Changes to National Laws and Regulations related to FDI indicates that 110 new FDI-related measures were introduced by a total of 55 countries. Of these, 85 measures were more favourable to FDI. Compared to the previous year, the percentage of less favourable measures for FDI has remained unchanged and stands at 23 per cent. From a regional perspective, South, East and South-East Asia and Oceania had the highest share of regulatory changes (25 per cent), followed by developed countries (20 per cent). In all regions, the number of changes more favourable to FDI clearly exceeded those that were less favourable. They accounted for 75 per cent of the 16 measures adopted in Africa, 79 per cent of the 28 measures adopted in South, East and South-East Asia and Oceania, 80 per cent of the 15 measures adopted in the CIS, 91 per cent of the 22 measures in the developed countries, 55 per cent of the 20 measures adopted in Latin America, and 89 per cent of the 9 measures taken in West Asia and the SEE countries combined. Out of the 110 new measures adopted during the review period, 33 per cent introduced more favourable entry regulations, and another 44 per cent of all measures improved the treatment or operations. Only 13 per cent and 10 per cent were less favourable in entry and treatment or operations, respectively.

3.2.4 Impact of the crisis on FDI-related policies

So far, the current financial and economic crisis has had no major impact on FDI policies per se. Although numerous countries have adopted FDI-related legislation since the beginning of the crisis, it is difficult to determine whether and to what extent these measures were taken in response to the crisis. Also, while some new legislation is likely to have a positive effect on FDI flows, other regulations might produce the opposite result. Moreover, the crisis has had a considerable psychological effect inasmuch as it has triggered large public support for a stronger role of the State in the economy in numerous countries. It cannot be ruled out that State involvement will continue beyond the actual crisis, with longer term effects on FDI policies in the future (UNCTAD, 2009: 30).

Figure 17

Key general "outer ring" policies affecting FDI



Source: Author.

3.2.5 Other national policies affecting FDI location

In addition to core FDI policies, a number of other policies ("outer ring" policies) at the national level influence TNCs' decisions with respect to locating in a host country (figure 17).

Some of them are policies that usually accompany core policies and complement the latter with respect to achieving FDI-related objectives. These include trade and privatization policies. Other policies that are also important as host-country determinants include tax, macroeconomic, and macro-organizational or structural policies. In addition, many other policies ranging from labour market policies to educational, environmental and sectoral policies affect FDI location in one way or another.

Trade policy plays a particularly prominent role in influencing FDI location (box 14). In the past, that role was assigned on the basis of substitutability between FDI and trade as modes of serving national markets for goods, so that liberal FDI policies were sometimes accompanied by restrictive trade policy; or on the basis of complementarity between FDI and trade in the efficient organization of international production, so that liberal FDI and trade policies went together, either in general or in specific sectors. Increasingly, however, liberal frameworks for trade are considered essential for the full benefits of liberal FDI frameworks on host-country FDI to be realized.

Box 14

FDI and trade policies

To attract FDI and to maximize its contributions to their import-substituting development strategies, in the 1970s and 1980s, countries in Latin America used a mix of protectionist trade policies combined with policies allowing FDI in manufacturing. Some Asian countries, in contrast, used both FDI and trade policies (e.g. exemptions from import duties) to encourage TNCs to contribute to their export-oriented economic strategies. A few, for example, Hong Kong (China) pursued *laissez-faire* trade and FDI policies. On the other hand, the FDI policies of such economies as the Republic of Korea, Taiwan Province of China and (previously) Japan were embedded in a broader set of industrial policies guiding and selectively inducing TNCs to link up with local firms to help increase local innovative and export capacities.

Source: UNCTAD (1998: 92).

Privatization policy that opens up the sale of State-owned enterprises to foreign investors can be a powerful determinant of FDI in a host country. If privatization is open to foreign investors, it expands the scope for FDI to enter sectors or industries previously closed to (domestic, private as well as) foreign investors. In industries characterized by natural or near-natural monopoly, where privatization simply leads to the transfer of a monopoly from the State to a private agent, the acquisition of a privatized enterprise can be attractive to foreign investors partly or largely because of lack of competition. The competition-policy aspects of such privatization-related FDI may be difficult to address, especially for developing host countries.

Tax policy can influence the investment location if the tax level is either significantly low or high compared to other countries. A very low level of corporate taxation can transform a country into a tax haven, but that would not necessarily attract productive investment and could have a negative impact on the public finances of the country; on the other hand, high taxes might discourage certain investments, especially in the case of small and medium-sized enterprises. Personal tax rates may affect managers' choices with regard to the location of regional headquarters and may affect the ability to hire foreign personnel, which may be important for FDI in certain industries. But all things being equal, a country with lower corporate tax rates should stand a greater chance of attracting an FDI project than a country with higher rates. Exceptions to general tax policies will be dealt with below under "incentives".

Macroeconomic policies including monetary, fiscal and exchange-rate policies influence FDI through their effects on economic (and thereby, political and social) stability in terms of parameters such as the rate of inflation and the state of external and budgetary balances, important for all types of investment. Their effects on interest rates and thus the cost of capital in a host country may also influence investment decisions, although the effects of host-country interest rates on FDI are smaller than on domestic investment, because TNCs normally have a greater choice of sources of financing. Fiscal policies also determine general tax levels, which, as noted above, can influence inward FDI. Exchange-rate policy is related to economic stability and may also influence FDI decisions by affecting the prices of host-country assets, the value of transferred profits and the competitiveness of exports by foreign affiliates. The importance of these factors was underlined by the results of a survey of executives of foreign affiliates, which found macroeconomic and political stability to be the most important factors in investment decision-making (UNCTAD, 2007b: 1).

Macro-organizational policies include policies influencing the industry composition of manufacturing (e.g. policies *vis-à-vis* sunset and sunrise industries), the spatial distribution of economic activities (e.g. regional development policies or creation of special economic zones), the functional composition of activities (e.g. policies aimed at encouraging R&D), the composition of activities by type of ownership (e.g. encouraging small enterprises) and intensity of competition (e.g. deregulation of certain services such as education or health). All of these policies can affect FDI and in particular, its composition: for example, policies to encourage technology-intensive activities in a country by offering tax breaks or other incentives to such activities may attract FDI in high-tech industries. Moreover, such policies are sometimes used specifically in the FDI context, as for example when tax-credits, information, or services are provided to facilitate technological partnerships between domestic and foreign companies.

Policies with respect to the functioning of factor markets, such as labour market policies may have either a discouraging or an encouraging impact on inward FDI.

Finally, policies that affect the supply and quality of human resources in a host country can affect not only the quantity of FDI a country receives but also its quality. Thus, educational and health policies that raise the supply and quality of human capital in a country can improve a country's locational advantages substantially in the long run and attract FDI into high-value added industries.

3.2.6 The impact of international policy frame works

In their efforts to attract FDI and to influence its quality, countries increasingly conclude international agreements dealing with an expanding set of issues related to FDI. A number of these instruments, as well as trade agreements, may influence some of the determinants of FDI in those countries, and thus, their FDI inflows (UNCTAD, 1998: 117-128).

3.2.7 Bilateral investment treaties

Bilateral investment treaties (BITs) are intended to protect investors from each of the treaty partner-countries operating in the other. They have increased significantly after 1990, with 2,676 signed at the end of 2008 (UNCTAD, 2009: 32). BITs exert some influence on members' national policy frameworks for FDI, especially by strengthening the bilateral standards of protection and treatment of foreign investors and establishing mechanisms for dispute settlement.

These policy improvements might be expected to exert some impact on FDI in countries with BITs, although, given the variety of host country determinants it cannot be expected to be significant. There is some evidence that foreign investors encourage governments of their home countries to conclude BITs with countries in which they already have investments, suggesting that BITs may play a role in maintaining existing levels of FDI. Comprehensive statistical analyses have, however, confirmed the relative insignificance of the role of BITs in influencing FDI flows and explaining differences in their size among countries. The major reason is likely to be that BITs, like other policy factors, are enabling in character and must be complemented by economic determinants and helped, in some cases, by investment facilitation measures. It is also possible that the rapid proliferation of BITs in the 1990s has eroded their influence as a signal to attract additional investments.

3.2.8 International trade and investment agreements

A large number of host countries today are signatories to trade or trade and investment agreements at regional, plurilateral and multilateral levels; e.g. there were 273 preferential trade and investment agreements (PTIAs) counted at the end of 2008 (UNCTAD, 2009: 33). Participation in such agreements can influence all three categories of FDI determinants in a host country including: economic factors, national policies with respect to FDI, and business facilitation. The nature and extent of such influence depends on the scope and depth of economic integration between member countries envisaged by an agreement, the credibility of an agreement, as manifested in the extent to which its provisions are actually implemented, and the prior interdependence of member countries and established linkages among them as indicated, for example, by the levels of trade and FDI barriers.

The scope of an agreement determines the extent of policy harmonization among member countries and hence, effects on FDI determinants in those countries. Regional trade agreements, that entail no more than tariff reductions among members can affect FDI determinants through their effects on trade or on strategic responses of investors to competitors, and through their effects on member economies' growth. On the other hand, agreements that cover investment – that is, also allow for the movement of capital (including FDI) – would be expected to have effects on investment determinants beyond those induced by trade liberalization, including through liberalization and harmonization of FDI frameworks among participant countries. As regulatory frameworks for FDI become more harmonized within a region or a group of countries, more importance is attached to economic determinants in deciding FDI location within the region. To a lesser extent, the importance of business facilitation also rises.

The credibility of an agreement or the extent to which it is implemented affects its impact on FDI determinants: failure to implement an agreement fully means that its impact on FDI determinants is limited. On the other hand, strict implementation of an agreement exerts greater influence on FDI determinants, especially those related to national FDI policies and economic conditions.

The degree of interdependence between countries prior to an agreement affects the extent to which an agreement reduces barriers to trade and FDI and hence, its impact on FDI determinants. For countries that have already established significant links – that is, already reduced barriers to trade and FDI significantly – the principal influence of trade and investment agreements would depend on how they address divergences in domestic policy.

The majority of international trade and investment agreements (apart from BITs) are regional agreements all of which liberalize trade and investment among members. Regardless of their scope and the degree of prior interdependence between member countries, they influence TNC decisions regarding location in a member country by making some country-specific location advantages less important as FDI determinants, and some region-specific advantages more important. Thus, even if trade and investment agreements have a positive impact on FDI determinants for the region as a whole, not all member countries necessarily benefit to the same extent. In particular, the size of the domestic market of large countries will no longer be as attractive, and other economic determinants specific to individual member countries or business facilitation at the local level can become more important.

3.3 Business facilitation

From the point of view of foreign investors, the liberalization of core national FDI policies discussed in section 3.2 is, above all, an enabling act aimed at creating a framework that establishes a level-playing field for all investors in a country and makes it possible for them to invest and establish production facilities in the country. This enabling act is increasingly complemented by proactive measures by host-country governments, aimed at facilitating FDI and the business that foreign investors undertake in a host country. With more and more countries adopting open FDI policies and actively seeking FDI to supplement their domestic resources and capabilities, such measures have become increasingly routine, pervasive and sophisticated.

One important category of such measures relates to FDI promotion, which includes a range of programmes and actions, typically undertaken by investment promotion agencies (IPAs) established (or transformed from earlier screening and monitoring agencies) for this purpose. Other business facilitation measures include the provision of incentives to foreign investors, the reduction of the "hassle costs" of doing business in a host country, and the provision of amenities that contribute to the quality of life of expatriate personnel in host countries. The discussion below focuses mainly on FDI promotion and incentives for FDI.

3.3.1 FDI promotion

Historically, the need for promotional action and measures arose when countries changed their attitudes and policies towards the role of FDI in their economies from negative to positive, but investors responded more weakly than desired. As that experience and others have made clear, when making investment decisions, TNCs do not have perfect – or sometimes even adequate – information about all host countries or locations; moreover, they dislike risk and prefer known locations and may even be biased and subjective. At the same time, when designing policies, governments need an understanding of what TNCs need or, more generally, need to become investor-friendly. Investment promotion activities can address both these shortcomings.

Over time, promotional activity has become more important and expanded its scope. The number of countries (developed, developing and transition economies) with investment promotion programmes has increased rapidly, judging from the membership of the World Association of Investment Promotion Agencies (WAIPA), which stood at 227 countries in April 2008 (WAIPA, 2008). The scope of investment promotion policy has grown from a first generation approach of simply liberalizing FDI policies to a second-generation one including marketing of countries as investment locations and setting up IPAs and most recently, to a third-generation one targeting foreign investors, marketing subnational regions and matching locational advantages with foreign investors' needs.

The key functions of FDI promotion at present include image-building, investment generation and targeting, investment facilitation, after-care servicing, and policy advocacy with respect to FDI.

Image building can play an important role, especially in countries that have changed their attitudes and policies towards the role of FDI in their development from negative to positive. Such countries often have an image problem because foreign investors continue to perceive them as places not friendly to FDI. Information and advertising campaigns highlighting policy changes can help change such perceptions. Such campaigns can also help shorten the delays in the reactions of investors to emerging investment opportunities, especially in countries that earlier attracted little FDI, or help investors, especially small and medium-sized firms, discover new opportunities they would not find on their own.

Investment generation and targeting are key components of investment promotion, comprising a wide range of efforts aimed at actually bringing in FDI. Investment generating measures can consist of direct mail or telephone campaigns or industry-specific missions. But the most important and promising – though at the same time difficult and costly – activity is targeting firms that are likely to respond to promotion efforts and to invest in a host country. Evidence suggests that the focus of IPAs on investment generation has increased – for example, according to a survey of 101 IPAs conducted by UNCTAD in 2000, "80 per cent of the agencies in the survey reported that investor targeting was one of their core functions" (UNCTAD, 2001: 13).

Investment-facilitation services are another increasingly important component of promotional activities in both developed and developing countries. Such services consist of counseling, accelerating the various stages of the approval process and providing assistance in obtaining all the needed permits. In many countries, they have led to the creation of "one-stop shops" – entities supposed to be able to handle all matters related to FDI projects. In the above survey 65 per cent of the responding IPAs indicated that they provided consulting services as one of their core functions (UNCTAD, 2001: 13).

After-investment services, or services rendered to established foreign affiliates regarding day-to-day operational matters, have become increasingly important under the pressures of competition for FDI in a globalizing world economy. The reasons for the inclusion of these services in investment promotion efforts are twofold. One is the realization that sequential investment – that is, reinvestment of earnings by established foreign affiliates – can be a significant source of FDI. If the expansion of a foreign affiliate is not possible for reasons beyond the reach of the host country (e.g. because of corporate strategy), a no less important objective is to retain the existing level of FDI. Secondly, there is a growing awareness that satisfied investors are the best evidence of a good investment climate in a host country and can help to attract other investors. Nearly 70 per cent of IPAs encouraged investment through after-care services, according to the above mentioned survey (UNCTAD, 2001: 14).

Policy advocacy has become one of the most useful and effective functions of investment promotion in recent years. IPAs are increasingly involved in advocating measures to improve the investment climate that address all areas of importance to investors. The importance of this function arises from the fact that the effectiveness of investment promotion in general depends significantly on not only the basic economic determinants in a host country but also the country's overall climate for investment, including FDI policies and practices with respect to their implementation. Eighty per cent of IPAs engaged in policy advocacy according to UNCTAD (2001: 13).

3.3.2 Incentives and other measures

Incentives are measurable economic advantages afforded to specific enterprises or categories of enterprises by (or at the direction of) governments (national, regional or local) in order to encourage them to behave in a certain manner. Governments use incentives to attract FDI to their respective countries, regions or localities (locational incentives), or to steer it into favoured industries or activities or to make foreign affiliates undertake functions such as training, local sourcing or R&D that it regards as desirable (behavioural incentives). Although most incentives today are directed to domestic and foreign investors alike, sometimes they target one of the two: for example, in some countries such as Ireland, the entire incentive scheme was geared to FDI for a long time. Overall, surveys indicate that the range of incentives and the number of countries (and provinces and local authorities) that offer them has increased considerably in recent years (UNCTAD, 2004a: 50).

The main types of investment incentives used by governments are financial incentives (e.g. outright grants and loans at concessional interest rates); fiscal incentives (e.g. tax holidays and reduced tax rates); and other incentives such as subsidized infrastructure or services, market preferences, and regulatory concessions, including exemptions from labour or environmental laws. The main rationale for providing incentives to attract FDI to a location (or an industry or activity therein) is the need to correct for the failure of markets to capture the wider benefits arising from externalities in production that may arise from economies of scale, diffusion of knowledge, or upgrading of skills. To the extent that such externalities exist in a host economy, they justify offering incentives to the point that the private returns equal social returns, although the latter may be difficult to calculate.

Major incentive packages have also been justified on the grounds that the attraction of one or a few "flagship" firms would signal to the world that a location has an attractive investment climate and lead other investors to follow. Incentives can also compensate investors for other government interventions, such as performance requirements or correct for an anti-export bias in an economy arising from tariffs or an overvalued exchange rate. They can, moreover, compensate for various deficiencies in the business environment that cannot easily be remedied.

It is generally agreed that incentives are rarely the main determinant of investment location decisions by TNCs. But where all else is equal, they can tilt the balance in favour of a particular location. However, although incentives may assist in attracting FDI flows to a location and may in principle be justified on the grounds mentioned above, they can involve significant costs for host governments and ensuring that the costs do not exceed the benefits involved is not easy. Locational incentives can be economically inefficient if they divert investment from other locations that would have been selected on economic grounds.

More importantly, if the offer of incentives by one country leads to a bidding war for FDI, host countries lose to the TNC (or its home country, if it can tax away the concessions). If incentives are used to address market failures, the first best policy may often be to correct the failure rather than to compensate for it. For these and other reasons, there is widespread view that countries should try to attract FDI not so much by offering incentives as by building genuine economic advantages and a favourable investment climate. Any incentive would decrease the benefits a country might be able to reap from FDI.

Other business facilitation measures related to FDI include measures for the reduction of "hassle costs" for foreign investors and for improving the quality of life in the host country for expatriate personnel employed by TNCs.

- **The reduction of "hassle costs"**. This is important because for an investor, supplementary costs deriving from factors such as bureaucratic inefficiency and red tape represent hidden costs due to unjustified charges and delays.

- **Measures related to the improvement of the quality of life** in the host country. For foreign investors, the host country is not only an economic environment, but also as a place to live. FDI involves not only the location of corporate functions but also, to a greater or less extent, some relocation of personnel. Thus, various **social amenities** (such as bilingual schools), that the host country offers, could be important for a foreign investor and influence the decision with respect to FDI location.

3.3.3 The effectiveness of business facilitation measures as host-country determinants

In considering the effectiveness of investment promotion, incentives and other business facilitation measures as FDI determinants, it has to be recognized that they can only play a supporting role and will rarely be decisive factors. If a host country does not have some basic economic determinants in place or if other components of the investment climate are unsatisfactory, no amount of promotional efforts or incentives will help it to attract significant FDI. Highly publicized cases of investment promotion activities underline this clearly (box 15).

Box 15

Investment promotion and FDI

One frequently cited case of successful investment-generating activities relates to US FDI in the Malaysian electronics industry, which was generated through investor targeting by Malaysia's Industrial Development Authority (MIDA) including specific investment missions to capital-exporting countries, particularly focusing on the electronics sector of the US. This success was possible because of the presence of broader economic and other factors such as the availability of productive human resources at competitive costs, well-developed transportation and communication infrastructure, a stable and open economy, and the widespread use of English. Moreover, these factors were well grounded in a broader effort aimed at establishing a favourable investment environment and covering in a comprehensive manner all areas of importance to investors.

Examples from other parts of the world, such as those of Ireland and Costa Rica, show a similar pattern: promotional efforts played a certain role, but this role was possible because of economic determinants that were continuously upgraded by government policies in such areas as education, infrastructure or the nurturing of small potential suppliers to foreign affiliates.

Source: UNCTAD (1998: 104).

With regard to incentives, there is much evidence that, overall, they are not an important element in the set of factors that determine inward FDI. Once a decision has been made, however, to undertake FDI in a given region or country, incentives may have an impact on influencing the precise choice of location within the region or country.

Thus, one should not overestimate the importance of investment promotion and other business facilitation measures as FDI determinants. Applied alone, they are not sufficient for FDI to take place in a location. Neither are they necessary in the way that an enabling policy framework for FDI is. But even if this category of determinants is not equal in importance to the other two categories, it should not be underestimated, because business facilitation measures can indeed make a difference – especially in little known investment locations or with concrete investment projects. Above all, as the convergence of investment regimes reduces the relative effectiveness of policy regimes as locational determinants, notable differences in business facilitation measures may assume greater significance when it comes to locational choice.

4 Conclusion

The key factors underlying FDI include firm-specific competitive advantages that enable firms to establish production facilities abroad, overcoming their disadvantages *vis-à-vis* local firms; location-specific advantages of host countries that can be combined with those competitive advantages to the benefit of the firms; and firm-specific internalization advantages due to which firms find greater benefits in exploiting both ownership and locational advantages through internalization, that is through FDI, rather than arm's length transactions. The main determinants of the location of FDI are host-country-specific economic factors, but national policy frameworks of host countries, the international policy frameworks in which host countries participate, and the business facilitation measures implemented by them also play important roles.

The economic determinants of FDI location fall into four clusters according to the motives of TNCs for investing abroad: resource-seeking, market-seeking, efficiency-seeking and strategic asset-seeking. Efficiency-related factors such as labour costs and productivity, skills, and other created assets are increasing in importance as TNCs, under competitive pressures in a globalizing world economy; increasingly seek to locate different parts of their value chain wherever they can contribute most to the firm as a whole. The national policy framework can play a key role through restricting or enabling FDI. But, as well as business facilitation, it is not sufficient in itself to attract FDI. However, with the increasing importance of created assets as FDI determinants, in the context of complex integration strategies pursued by TNCs, the role of host country policies and business facilitation can become more significant.

The interaction between various determinants, the shift of their importance in time and from one region to another, as well as the need to consider them in the light of the different motives and strategies of the foreign investors makes it difficult to assess the separate impact of each determinant on FDI or to rank them according to their importance. In most cases, the economic determinants are fundamental but, when economic conditions are similar, other determinants can make a difference

Exercises and questions for discussion

1. What are the three main sets of factors that determine FDI?
2. Give reasons for the decline in the relative importance of FDI in natural resources.
3. What are the main determinants of market-seeking FDI? Discuss in groups the reasons for and the conditions in which they might influence the investment decision.
4. What are the main features of a simple integration strategy and of a complex integration strategy? What are the main host country determinants relevant for FDI under each strategy?
5. Give examples of determinants of efficiency-seeking FDI. Discuss in groups how they could relate to other host-country economic determinants.
6. Explain the concept of created assets and give examples. Explain why created assets can constitute an important locational advantage for a host country. Discuss your arguments in groups.
7. What are the main categories of host country economic determinants? What are the main aspects that should be considered when assessing the relative importance of various host country determinants of FDI? Discuss them in groups.
8. What are core FDI policies? What other policies can influence FDI in a country?
9. What are the main characteristics of the FDI liberalization process?
10. What are the main types of macroeconomic and macro-organizational policies that could have an impact on FDI? Discuss examples from your country or region.
11. Discuss the role that trade policy can play in attracting FDI.
12. Discuss the impact of the international policy framework on FDI.
13. Name at least three investment promotion activities that might influence the investment decision.
14. Define incentives and name their main purposes. What are the main types of incentives? Give examples of each type.
15. Explain what "hassle costs" mean and their possible effects for investors.
16. Discuss the possible impact of promotional measures and incentives on FDI. Compare it with the impact of other host country determinants.
17. Discuss in three groups the relative importance of different host country determinants: Each group represents one category of determinants and should try to demonstrate the importance of that category against the other two.

18. **Practical exercise**

China and India: What explains their different FDI performance? (UNCTAD, 2003)

China and India are the giants of the developing world. Both enjoy healthy rates of economic growth. But there are significant differences in their FDI performance. FDI flows to China grew from US$3.5 billion in 1990 to US$52.7 billion in 2002; if round-tripping is taken into account, China's FDI inflows could fall to, say, US$40 billion.[a] Those to India rose from US$0.4 billion to US$5.5 billion during the same time period (see table below).[b] Even with these adjustments, China attracted seven times more FDI than India in 2002, 3.2% of its GDP compared with 1.1% for India.[c] In UNCTAD's FDI Performance Index, China ranked 54th and India 122nd in 1999-2001.

FDI has contributed to the rapid growth of China's merchandise exports, at an annual rate of 15% between 1989 and 2001. In 1989 foreign affiliates accounted for less than 9% of total Chinese exports; by 2002 they provided half. In some high-tech industries in 2000 the share of foreign affiliates in total exports was as high as 91% in electronics circuits and 96% in mobile phones (*World Investment Report 2002*: 162-163). About two-thirds of FDI flows to China in 2000-2001 went to manufacturing.

In India, by contrast, FDI has been much less important in driving India's export growth, except in information technology. FDI in Indian manufacturing has been and remains domestic market-seeking. FDI accounted for only 3% of India's exports in the early 1990s (*World Investment Report 2002*: 154-163). Even today, FDI is estimated to account for less than 10% of India's manufacturing exports (UNCTAD forthcoming a).

For China the lion's share of FDI inflows in 2000-2001 went to a broad range of manufacturing industries. For India most went to services, electronics and electrical equipment and engineering and computer industries. What explains the differences? Basic determinants, development strategies and policies and overseas networks.

Exercises and questions for discussion

Basic determinants: On the basic economic determinants of inward FDI, China does better than India. China's total and per capita GDP are higher (see table below), making it more attractive for marketseeking FDI. Its higher literacy and education rates suggest that its labour is more skilled, making it more attractive to efficiency-seeking investors (World Bank, 2003c: 234; UNDP, 2002). China also has large natural resource endowments. In addition, China's physical infrastructure is more competitive, particularly in the coastal areas (CUTS, 2003; Marubeni Corporation Economic Research Institute, 2002). But, India may have an advantage in technical manpower, particularly in information technology. It also has better English language skills. Some of the differences in competitive advantages of the two countries are illustrated by the composition of their inward FDI flows. In information and communication technology, China has become a key centre for hardware design and manufacturing by such companies as Acer, Ericsson, General Electric, Hitachi Semiconductors, Hyundai Electronics, Intel, LG Electronics, Microsoft, Mitac International Corporation, Motorola, NEC, Nokia, Philips, Samsung Electronics, Sony, Taiwan Semiconductor Manufacturing, Toshiba and other major electronics TNCs. India specializes in IT services, call centers, business back-office operations and R&D.

Rapid growth in China has increased the local demand for consumer durables and nondurables, such as home appliances, electronics equipment, automobiles, housing and leisure. This rapid growth in local demand, as well as competitive business environment and infrastructure, have attracted many market-seeking investors. It has also encouraged the growth of many local indigenous firms that support manufacturing.

Other determinants related to FDI attitudes, policies and procedures also explain why China does better in attracting FDI.

- China has "more business-oriented" and more FDI-friendly policies than India (AT Kearney, 2001).
- China's FDI procedures are easier, and decisions can be taken rapidly.
- China has more flexible labour laws, a better labour climate and better entry and exit procedures for business (CUTS, 2003).

A recent business environment survey indicated that China is more attractive than India in the macroeconomic environment, market opportunities and policy towards FDI. India scored better on the political environment, taxes and financing (EIU, 2003a). A confidence tracking survey in 2002 indicated that China was the top FDI destination, displacing the United States for the first time in the investment plans of the TNCs surveyed; India came 15th (AT Kearney, 2002). A Federation of Indian Chambers of Commerce and Industry (FICCI) survey suggests that China has a better FDI policy framework, market growth, consumer purchasing power, rate of return, labour laws and tax regime than India (FICCI, 2003).

Development strategies and policies: The different FDI performance of the two countries is also related to the timing, progress and content of FDI liberalization in the two countries and the development strategies pursued by them.

- China opened its doors to FDI in 1979 and has been progressively liberalizing its investment regime. India allowed FDI long before that but did not take comprehensive steps towards liberalization until 1991 (Nagaraj, 2003).
- The two countries focused on different types of FDI and pursued different strategies for industrial development. India long followed an import-substitution policy and relied on domestic resource mobilization and domestic firms (Bhalla, 2002; Sarma, 2002), encouraging FDI only in higher-technology activities. Despite the progressive liberalization, imposition of joint venture requirements and restrictions on FDI in certain sectors, China has, since its opening, favoured FDI, especially export-oriented FDI, rather than domestic firms (Buckley, forthcoming; IMF, 2002). Such policies not only attracted FDI but led to round-tripping through funds channelled by domestic Chinese firms into Hong Kong (China), reinvested in China to avoid regulatory restrictions or obtain privileges given to foreign investors. In India, round-tripping, mainly through Mauritius, is much smaller and for tax reasons.

It has been suggested that domestic market imperfections associated with problems of outsourcing, regulations and local inputs have led to "excessive internalization" of production activities by TNCs in China. So part of the FDI, occurring because of the imperfections of the domestic market, is undertaken as a second best response by manufacturing TNCs to the Chinese environment (Buckley, forthcoming).

Exercises and questions for discussion

China and India: selected FDI indicators, 1990, 2000-2002

Item	Country	1990	2000	2001	2002
FDI inflows (million dollars)	China	3,487	40,772	46,846	52,700
	India	379	4,029	6,131	5,518
Inward FDI stock (million dollars)	China	24,762	348,346	395,192	447,892
	India	1,961	29,876	36,007	41,525
Growth of FDI inflows (annual, %)	China	2.8	1.1	14.9	12.5
	India	-6.1	16.1	52.2	-10.0
FDI stock as percentage of GDP (%)	China	7.0	32.3	33.2	36.2
	India	0.6	6.5	7.4	8.3
FDI flows as percentage of gross fixed capital formation (%)	China	3.5	10.3	10.5	..
	India	0.5	4.0	5.8	..
FDI flows per capita (million dollars)	China	3.0	32.0	36.5	40.7
	India	0.4	4.0	6.0	5.3
Share of foreign affiliates in total exports (%)	China	12.6	47.9	50.0	..
	India	4.5	..	..	..
GDP (billion dollars, current prices)	China	388	1,080	1159.1	1237.2
	India	311	463	484	502
Real GDP growth (%)	China	3.8	8.0	7.3	8.0
	India	6.0	5.4	4.2	4.9

Source: UNCTAD, FDI/TNC database; IMF, World Economic Outlook database, April 2003.
Note: See note b for explanation for the data on FDI flows and stocks in India. FDI flows and stocks data for India in 2000 and 2001 are based on fiscal year 2000/01 and 2001/02.

For India the situation is somewhat different. A tradition of entrepreneurship has spawned a broad based domestic enterprise sector (Huang and Khanna, 2003). This combines with the necessary legal and institutional infrastructure and a restrictive FDI policies followed until the 1990s. As a result, TNC participation in production has often taken externalized forms (such as licensing and other contractual arrangements). Even after a significant liberalization of FDI policies, internalization is not necessarily dominant. Consider information technology, industries where outsourcing to private Indian firms is efficient and there are quality domestic subcontractors.

China's accession to the WTO in 2001 has led to the introduction of more favourable FDI measures. With further liberalization in the services sector, China's investment environment may be further enhanced. For instance, China will allow 100% foreign equity ownership in such industries as leasing, storage and warehousing and wholesale and retail trade by 2004, advertising and multimodal transport services by 2005, insurance brokerage by 2006 and transportation of goods (railroad) by 2007. In retail trade, China has already opened and attracted FDI from nearly all the big-name department stores and supermarkets such as Auchan, Carrefour, Diary Farm, Ito Yokado, Jusco, Makro, Metro, Pricesmart, 7-Eleven and Wal-Mart (PriceWaterhouseCoopers, 2002).

In India the Government is planning to open some more industries for FDI and further relax the foreign equity ownership ceiling (EIU, 2003a). To identify approaches to increase FDI flows, the Planning Commission established a steering committee on FDI in August 2001. Following the Chinese model, India recently took steps to establish special economic zones. China's special economic zones have been more successful than Indian export processing zones in promoting trade and attracting FDI (Bhalla, 2002).

Overseas networks: In addition to economic and policy-related factors, an important explanation for China's larger FDI flows lies in its position as the destination of choice for FDI by Chinese businesses and individuals overseas, especially in Asia. The role of the Chinese business networks abroad and their significant investment in mainland China contrasts with the much smaller Indian overseas networks and investment in India (Bhalla, 2002). Why? Overseas Chinese are more in number, tend to be more entrepreneurial, enjoy family connections (*guanxi*) in China and have the interest and financial capability to invest in China – and when they do, they receive red-carpet treatment. Overseas Indians are fewer, more of a professional group and, unlike the Chinese, often lack the family network connections and financial resources to invest in India.

Exercises and questions for discussion

Both China and India are good candidates for the relocation of labour-intensive activities by TNCs, a major factor in the growth of Chinese exports. In India, however, this has been primarily in services, notably information and communication technology. Indeed, almost all major United States and European information technology firms are in India, mostly in Bangalore. Companies such as American Express, British Airways, Conseco, Dell Computer and GE Capital have their back-office operations in India. Other companies – such as Amazon.com and Citigroup – outsource services to local or foreign companies already established in the country (AT Kearney, 2003). Foreign companies dominate India's call centre industry, with a 60% share of the annual US$1.5 billion turnover. Investor sentiment on China as a location for investment is improving (MIGA, 2002; AT Kearney, 2002; American Chamber of Commerce in China, 2002). Nearly 80% of all Fortune 500 companies are in China (*World Investment Report 2001*: 26), while 37% of the Fortune 500 outsource from India (NASSCOM, 2001). Despite the improvement in India's policy environment, TNC investment interest remains lukewarm, with some exceptions, such as in information and communication technology (AT Kearney, 2001).

The prospects for FDI flows to China and India are promising, assuming that both countries want to accord FDI a role in their development process – a sovereign decision. The large market size and potential, the skilled labour force and the low wage cost will remain key attractions. China will continue to be a magnet of FDI flows and India's biggest competitor. But, FDI flows to India are set to rise – helped by a vibrant domestic enterprise sector and if policy reforms continue and the Government is committed to the objective of attracting FDI flows to the country.

Questions:

- What are the economic factors that, in your view, explain the difference in the value of FDI inflows to China and India?
- What are the factors related to policies and business facilitation that, in your view, explain the difference in the value of FDI inflows to China and India?
- What are the differences in the type and industrial distribution of FDI attracted by China and India? How would you explain the difference?

Note: All references cited in the practical exercise are listed in UNCTAD (2003).
[a] FDI flows to China are generally considered to be over-reported due to the inclusion of round tripping (investment from locations abroad by investors from China) in China's FDI data, while those to India were under-reported due to the non-inclusion of reinvested earnings and intra-company loans in that country's data. Zhan (1995: 91-92) estimated that round-tripping to China was less than 25%, the prevailing estimate at the time (Harrold and Lall, 1993). However, with China's accession to the WTO in December 2001 and the removal of preferential treatment to foreign investors over domestic investors, round-tripping of Chinese FDI is likely to fall (World Bank 2003a: 102). The Bank of China Group indicated in an article that "... the market's general assessment is that the ratio (round-tripping to China) has declined from 30% to around 10–20% in recent years." ("Foreign direct investment in China", Hong Kong Trade and Development Cooperation, 1 January 2003. Published online at: *http://www.tdctrade.com/econforum/boc/boc030101.htm*).
[b] Based on the revised FDI data methodology, which includes the three components of FDI, India reported that FDI flows to the country increased from US$4.1 billion in fiscal year 2000/01 to US$6.1 billion in fiscal year 2001/2002. This means that actual inflows were about 60% higher than those reported earlier. This ratio is applied to arrive at the 1990 and the 2002 data for India. (The data in the annex to this report are still old ones, as the new ones arrived after closure of the statistical work).
[c] The figure for China after taking into account round-tripping (25% of FDI flows). The figure for India is based on the methodology mentioned in note b.

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THEME 4
FDI and development

INTRODUCTION

Sustainable development, including economic progress as well as advancement in social, environmental and other aspects of human well-being, is an urgent need in many countries. FDI and international production by TNCs can contribute to the development process of countries in a number of ways, particularly in the present context of a globalizing world economy. The potential for such contribution relates mainly to economic development, and arises because FDI is a package of productive assets and because the TNCs deploying them are now important participants in the global economy. However, TNCs are not agents of development; they seek to advance their profit positions, not to develop host economies. Moreover, they cannot substitute for domestic efforts – they can only provide access to tangible and intangible assets and capabilities and thereby add to, complement and catalyze domestic investment and capabilities. In a world of intensifying competition and accelerating technological change, their complementary and catalytic role can be very valuable. At the same time, because the objectives of TNCs differ in several respects from those of host countries, there is scope for adverse effects.

The global context for development and for TNC activity worldwide has changed enormously over the past three decades. Knowledge-intensive production, rapid technological change, shrinking economic space and greater openness of countries to international transactions have made attaining development goals more challenging than ever for countries. They have enhanced opportunities for countries to access resources and markets internationally. The same factors have also created opportunities and challenges for TNCs, expanding their access to resources and markets worldwide and increasing competitive pressures to utilize the new opportunities in the most efficient manner possible. As a result, more and more firms are investing abroad, while countries increasingly seek to attract FDI. However, given the different sets of objectives of countries and those of TNCs, countries need to develop their capacities and formulate policies to attract FDI as well as to manage its impact on key aspects of national development so as to maximize its benefits for their development process.

At the end of this theme, students should be able to:

- Understand the role of FDI and TNC activity in host-country development in terms of the potential benefits and disadvantages that they involve under different host-country conditions;

- Analyze the impact of FDI on key areas of host-country development including increasing investible resources and investment, enhancing technological capabilities, boosting export competitiveness, generating employment and strengthening skills, maintaining competition, and protecting the natural environment; and

- Understand the role of policy measures in enhancing the positive and minimizing the negative impacts of FDI.

HANDBOOK

1 The role of FDI in development

Development priorities of countries include achieving sustained income growth for their economies by increasing investment rates, strengthening technological capacities and skills, and improving the competitiveness of their exports in world markets; distributing the benefits of growth equitably by creating more and better employment opportunities; and protecting and conserving the natural environment for future generations. The new, more competitive context of a liberalizing and globalizing world economy in which economic activity takes place imposes considerable pressures on developing countries to upgrade their resources and capabilities if they are to achieve these objectives. This new global context is characterized by knowledge-intensive production, rapid technological change, shrinking economic space, rapid changes in competitive conditions and evolving attitudes and policies with respect to international trade, investment and other flows.

FDI and international production by TNCs can play an important role in the development process by supplementing and complementing the efforts of national firms and other economic agents. FDI comprises a bundle of tangible and intangible assets that are at the same time resources for development or can bring development benefits. Key assets and resources include capital, technology, skills and management techniques, market access, and clean environmental technologies. Many of them are firm-specific assets that TNCs exploit through FDI, and the impact of a TNC's activity on a host economy and its development arises from the specific package of assets it brings to the country and from its organization of productive activities across national boundaries and, crucially, on the host country's ability to find ways to capture benefits from the TNC's activities in their country.

Globalization accentuates the importance of the international economy for developing countries and because TNCs are important participants in the process of globalization, it enhances the importance of their role in host country development. The new global context mentioned above poses new challenges for developing countries as well as TNCs. As countries increasingly seek to attract FDI and firms increasingly invest abroad to take advantage of the opportunities as well as pressures from the new global context, policies and measures to maximize the contribution that FDI can make to development become particularly important. Given that the objectives of TNCs – primarily, profit and competitiveness – and those of countries – primarily sustainable development – do not necessarily overlap entirely, countries need to build their own capabilities and pursue policies to harness the potential of FDI and minimize its dangers to their development goals.

Given the incentive and capability structures of the host economy, direct investment by a TNC into a host-country project can offer substantial net benefits to the host economy. The behaviour of the TNC may not differ from that of comparable local firms, but the ownership and internalization advantages it possesses over local counterparts, to the extent they are transferred and deployed in host country-affiliates, are generally of potential benefit to host countries. Benefits can arise in the form of production of new or better goods and services, lower costs of production and/or, higher export sales and, depending on local conditions, the dissemination of the capabilities underlying these benefits to host-country firms and other economic agents. If TNCs engage in anti-competitive behaviour or other adverse business practices based on their size or transnationality, however, net benefits will be lower or even negative.

Analyzing and evaluating the impact of FDI and TNC activity overall on host country development requires an understanding not only of the motivations, strategies, and firm-specific advantages of the TNCs involved , but also the characteristics of a host country. The entry of TNCs, with various internalized markets for intangible assets and physical (intermediate) products, can strongly affect the development of markets and economic agents in host countries. It can boost the efficient development of some economies while retarding that of others, the precise outcome depending upon the existing level of development of host country markets, local enterprises and relevant institutional structures (Lall, 1993: 4). Evaluating these different outcomes is not easy: it requires gauging the alternative, or alternative situation of what may have happened in the absence of the TNC activity. This is extremely difficult, not only because of lack of hard data but also because different counterfactual situations may assume different government strategies and differing responses by domestic economic agents. Furthermore, it is also difficult to measure all costs and benefits associated with a specific investment of a TNC in a host country.

Although conceptual problems in defining strategic alternatives (along with a scarcity of data and complexity of issues) are a problem for evaluating the overall impact of FDI on a host economy, it is possible to proceed by assuming that plausible alternatives will depend crucially on the level of development already achieved in a host country (Lall, 1993: 20). For example, the realistic alternative to TNC activity in a least developed country may not be a competitive domestic private sector, while in some middle-income countries it may be a feasible one.

Given strategic alternatives, the impact of FDI on a host country depends, like that of investment generally, on the incentive and capability structures within which TNCs operate: the more conducive host-country policies and institutions are to private sector activity and competition and to FDI, and the more developed local skills, supplier networks and physical, scientific and institutional infrastructure, and the ability of government to successfully regulate and govern (all influencing the absorptive capacities of the host economy), the greater the contribution of FDI, given its particular type, industries involved and the related package of assets it provides.

The sections below focus on the extent to which FDI can make a contribution to each of the key areas of economic development and how this contribution can be enhanced through policy measures. The main areas considered relate to investible financial resources and investment; technological capabilities; trade competitiveness; employment and skills base, the environment and competition.

Box 16

Link between FDI and development – four perspectives

(a) The reigning orthodoxy in neo-liberal economics

The reigning orthodoxy in neo-liberal economics on FDI boils down to five canonical "truths":

- FDI is necessary for the development of the Third World.
- Without FDI there will be no growth.
- FDI brings *inter alia* efficient management of resources, technology, a culture of competition, and access to global markets.
- Nobody is forcing the South to seek FDI; the governments themselves want it.
- The private sector is the engine of growth; hence countries in the South must deregulate their economies, and privatize State assets as fast as possible.

More than 90per cent of literature, and third world government policies, are dominated by this view.

In a brief paper, it is not necessary to repeat the arguments. The principal argument, simply stated, is the following: Aid and loans in the 1960s and 70s created "aid dependency" and the debt crisis in the 1980s and 90s. FDI is the best source of development finance, on the grounds, among other, that it is self-liquidating since foreign investors have to show profits for the host country as well as for themselves; and it does not lead to debt overhang

(b) FDI is neither good nor bad; it all depends on how you deal with it

A more qualified proposition is made (e.g. in the Oxfam Briefing paper) that "properly regulated" FDI can bring growth, jobs, technology, skills, market access and development; that its negative effects must be balanced with its good effects; or that FDI must be "sequenced", or be subject to some kind of Tobin Tax. FDI is neither good nor bad; it all depends on how you deal with it. This view is now becoming popular in many circles, including some reformed neo-liberal economists, especially after the East Asian and Argentina crises of 1997-2001.

(c) Aid created debt crisis; FDI will create an even greater crisis of development

More recent empirical evidence suggests a completely different picture. Analysts like David Woodard argue that if aid created the debt crisis, FDI will create an even greater crisis of development, looming not in too distant future. This view challenges both the reigning neo-liberal orthodoxy, and the above stated more qualified perspective. The view is further explored below in the next section

d) FDI is not a development tool at all; it is a response to systemic crisis of the developed countries

A more radical alternative view is presented in a separate SEATINI Fact Sheet (What is FDI?). It argues that FDI, essentially, is a tool (one among many) in the economic arsenal of the developed industrialised countries in their overall strategy to control the resources and markets of the South. This control is necessary in order for Western corporations to counter against the downward pressure that is continually exerted by workers on corporate profitability. FDI is a means to resolve the West's own systemic contradictions. Contrary to its claim, it is not a means to assist the developing countries. However, FDI is well marketed by the West through "development" literature and through institutions such as the IMF, the World Bank, the WTO, and even the UNCTAD.

Source: Tandon (2004).

2 Increasing financial resources and investment

Investment, defined as expenditure on capital goods and other expenditures that add to production capacity, is a key factor in economic growth. Economic theory as well as empirical evidence suggests strongly that countries that devote a high proportion of output to investment sustain more rapid growth than countries that invest less. In a closed economy, with no access to foreign savings and no participation by foreign enterprises in economic activity, investment is undertaken solely by domestic firms and financed solely from domestic savings. In open economies, foreign savings in the form of inflows of private financial resources (FDI, portfolio flows and commercial bank lending) and, in the case of poorer countries, official development assistance (ODA) permit domestic investment to exceed domestic savings. However, most countries with high investment rates are also found to have high rates of domestic savings, implying that the role of foreign financial flows is generally to add to rather than replace domestic savings.

Because it generally involves capital inflows (as part of a package of resources) invested directly by TNCs in host countries, FDI affects the volume and characteristics of investible, available financial resources as well as actual investment in host countries. In this process, it also affects the balance of payments of host countries and the division of benefits from investments between the host country and other countries.

The overall impact of FDI on investible financial resources and investment in host countries depends, among other things, on host-country conditions. It is different in countries with abundant savings and other inflows of external capital than in countries without enough capital relative to their investment needs or demand. It also depends on the mode of entry of foreign affiliates' FDI (greenfield FDI or M&As), the activities they undertake (existing or not existing in a host country), the way the FDI is financed (reinvested earnings, intra-company loans or equity capital from parent companies) and the ways in which the activities of domestic companies are affected.

2.1 Impact on financial resources for development

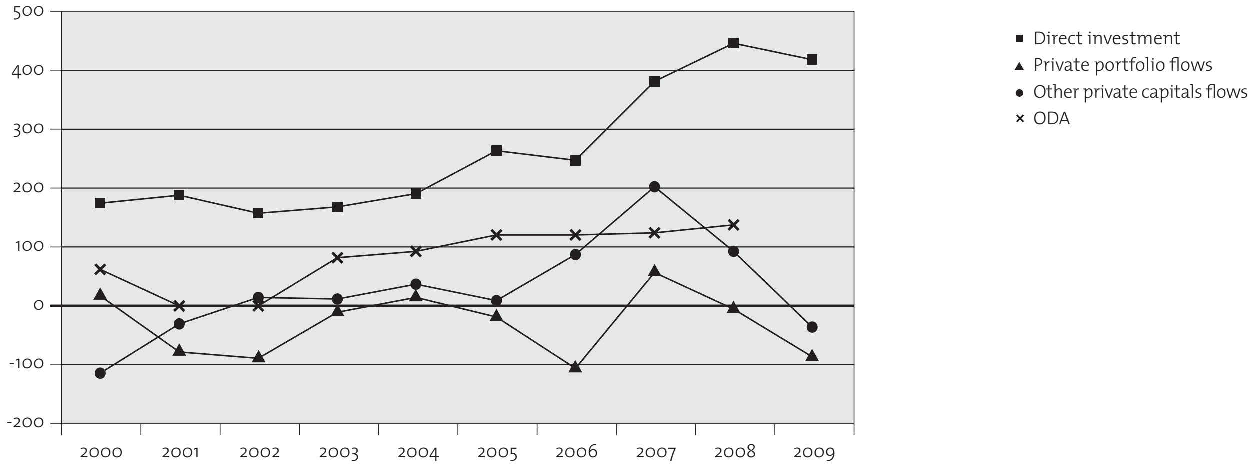
Over the past decade or more, inflows of FDI have become the single largest source of foreign savings – including private funds in the form of FDI, portfolio finance and bank lending and official development assistance – for developing countries as a group (figure 18). FDI flows account, however, for only part of the financing of foreign affiliates in host countries. They are internal to a TNC system, originating in a parent company or from retained earnings. Affiliates can also raise funds from sources external to their corporate systems. To the extent such funds are raised in international markets, they also increase the inflow of foreign financial resources for investment in host countries. Data for the US suggests that these additional resources TNCs bring to host countries may be almost as high as FDI inflows themselves (UNCTAD, 1999b: 160).

In considering the contribution of FDI to external financing, one of the components of FDI, retained earnings, needs special attention. Retained or reinvested earnings of foreign affiliates may be viewed not as an infusion of fresh capital from abroad but as domestic savings in the host country. However, these earnings are included in FDI inflows in the balance of payments, the assumption being that the parent firm could have repatriated the funds, but decided to reinvest them. Reinvested earnings accounted for about 30 per cent of FDI flows to developing countries, on average, during the period 1995-2004 (UNCTAD, 2005: 11). Global reinvested earnings of foreign affiliates in 2008 as a whole increased marginally, from US$468 billion in 2007 to US$487 billion in 2008, those in the first quarter of 2009 fell by roughly 40per cent from the same period in 2008, sharply reversing the trend of previous years and contributing further to the downward movement in FDI inflows (UNCTAD, 2009: 6).

As a source of finance, FDI has some advantages over other sources of foreign finance to developing countries. It is more stable than other types of private flows (bank lending and portfolio flows), because it is typically based on a longer-term view of the market, the growth potential and the structural characteristics of recipient countries. The risk of "herd behaviour" is also less likely than in the case of other flows. Divestment is more difficult for FDI than portfolio investment, especially in the case of FDI embodied in physical capital. FDI flows can, however, include a component of portfolio flows. Most studies have found that FDI is less volatile than other private flows (UNCTAD, 1999b: 161).

Figure 18

FDI and other resource flows to developing countries, by type of flow (billions of US dollars)



Source: UNCTAD (2009: 5).

FDI – and foreign portfolio investment – is also easier to service than commercial loans. Profits are repatriated only when a project yields a return. This has a marked advantage over bank lending, which must be repaid with fixed interest regardless of the performance of the project for which it was used, or of the macroeconomic conditions affecting all undertakings in the borrowing country.

As a source of external finance, FDI supplements domestic savings and contributes to growth through the financing of investment. It is possible, however, that FDI could effectively substitute for domestic savings, resulting in their reduction and enabling increased consumption. An excess inflow of FDI (like any other type of capital inflow) in a short period may also lead to the appreciation of the exchange rate of the national currency and reduce the competitiveness of exports, thus leading to a reduction of investment in export industries.

A profitable FDI project, unlike an identical project financed locally, must necessarily result in outflows of direct investment income from host countries at some point or points in time. These outflows, and the outflows of repatriated capital that occur when foreign affiliates eventually close down, raise concerns regarding the balance-of-payments impact of FDI.

There are many projects, however, that can be undertaken only by foreign investors, or which could not be undertaken at comparable levels of efficiency by domestic firms. Moreover, comparisons of financial inflows and outflows related to FDI alone cannot capture all the balance-of-payments effects of FDI. Whether FDI has a positive or negative impact on a host country's balance of payments depends on several factors: the size of FDI inflows (net of disinvestment); outflows of direct investment income; the export and import propensities of foreign affiliates and import requirements of a specific FDI projects; the indirect impact of FDI on foreign factor income outflows; the indirect impact of FDI on the export and import propensities of domestic firms; and the indirect impact of FDI on import demand by consumers in the country.

The balance-of-payments impact of FDI was of considerable interest to developing countries during the 1970s, when most developing countries faced serious foreign-exchange constraints (UNCTAD 1999b: 165). These constraints are for many countries less stringent today, when many developing countries are integrating themselves more closely into international goods and financial markets and adjusting their macroeconomic and exchange-rate policies accordingly. However the issue remains relevant for many countries, particularly the LDCs.

The balance-of-payments effects of FDI, as well as the distribution of value added by foreign affiliates between host and home countries can be affected by transfer pricing – the pricing by TNCs of intra-firm transactions across national boundaries. TNCs often have considerable freedom in pricing such transactions, particularly when there are no arm's length prices to serve as a reference. This allows TNCs to shift profits between countries to lower their tax burden or escape other restrictions on repatriating or declaring profits. The risk for the host country of losing benefits due to transfer pricing practices arises when there are large differences in tax regimes between countries and there are no double taxation agreements in force. Concern about transfer pricing, greatest in the

1960s and 1970s, has declined as tax differences have narrowed, double taxation treaties have proliferated and the desire to attract FDI has become widespread. Efforts to counter transfer pricing are now undertaken primarily by the tax authorities of major home countries like the US and Japan.

2.2 Impact on investment

In distinction from other sources of external capital such as bank loans or portfolio equity flows, FDI internalizes the flow of foreign savings to host countries – firms bring in the savings (along with other assets and resources in the FDI package) to undertake investment themselves. Thus FDI affects investment in host countries directly through the investment expenditures in foreign affiliates. It also affects investment in host countries indirectly, by affecting investment by host-country firms.

The value of investment expenditure by foreign affiliates in a country is not necessarily equal to FDI inflows (net flows of equity, reinvested earnings and intra-company loans by direct investors) to the country. Resources can also be raised in local and international capital markets to add to internal flows of FDI capital by TNCs. At the same time, FDI inflows include components that are not used for the financing of foreign-affiliate investment expenditures. For example, FDI inflows include flows for M&As in host countries which go towards changing the ownership of existing assets and do not contribute to capital formation in the host country at the time of entry, although they may lead to investment in the future through sequential investment by foreign affiliates. Data on US FDI abroad suggest that capital expenditures by foreign affiliates usually exceeded the value of FDI inflows by one third more in the case of developing host countries from 1989-1996 (UNCTAD, 1999b: 169).

An examination of the direct impact of foreign affiliates' investment on the size of host countries' total investment requires that the investment of these affiliates be compared with the investment of domestic firms; but countries do not typically disaggregate their investment expenditures into these categories. Using FDI inflows as a proxy for investment by foreign firms (although the latter can exceed FDI inflows, as noted above) and GFCF as a measure of total investment in host countries, data shows that the importance of FDI relative to total investment has increased consistently for all groups of countries, developed and developing. For developing countries as a group, the ratio of FDI to GFCF increased from an average of 2 per cent during 1971-1980 to nearly 4 per cent in 1981-1990 and 7 per cent during 1991-1999 (UNCTAD, 1999b: 168). In 2008, the ratio stood at 12.8 per cent (UNCTAD, 2009: 257). In spite of its growing importance, FDI still plays, on average, a modest role in total investment in all country groups, not exceeding 10 per cent in the majority of countries.

In addition to its direct effect, FDI may also affect the volume of host-country investment indirectly by crowding-in (stimulating entry of) or crowding out (inducing exit of) domestic investment. Either is possible, depending on activities undertaken by TNCs, the strength of local enterprises and the functioning of local factor markets. TNCs may crowd in domestic investment when they introduce new goods and services to the host economy that may offer new investment opportunities for domestic firms, create upstream or downstream linkages with domestic producers, and do not pre-empt local credit or even increase the efficiency of financial intermediation. The key factor determining crowding in domestic investment is the existence or creation of backward or forward linkages with host-country enterprises.

FDI may crowd out domestic investment by entering activities already populated by local firms in which there is little room for further expansion, in which domestic firms are unable to compete with foreign affiliates, or by using their size and "bankability" to gain privileged access to local capital markets. The net effect of such crowding out on total host country investment depends on what happens to the released resources: if they go into other activities in which local firms have greater competitive advantages, there will be no crowding out of domestic investment in the economy as a whole.

Experience at industry and country levels regarding the indirect impact of FDI on total host-country investment is mixed (UNCTAD, 1999b: 172-173).

2.3 Conclusion and policy implications

FDI inflows can supplement domestic financial resources for development and can add, directly or indirectly, to domestic investment in host developing countries. TNCs can undertake investment projects that may be beyond the reach of domestic investors. But FDI can also have adverse effects such as crowding out of domestic investors, and shifting of funds out of the host country through transfer pricing and thus not paying taxes where profits are earned. Moreover, while nearly all developing countries try to attract FDI to supplement their domestic financial resources and complement domestic investment, FDI inflows only account for a small share of total investment in most developing countries.

To attract FDI and benefit from it, governments can (and do) implement a range of measures. One of the most important requirements for attracting FDI is the establishment of an enabling policy framework for FDI. As noted (Module 1, theme 3), developing countries' national policies in the past two decades have generally been characterized by a trend towards liberalization of the regulatory frameworks for inward FDI: entry and establishment have been made easier by reducing sectoral restrictions on FDI, either by expanding the positive list of industries in which FDI is permitted or by reducing the negative list of industries closed to FDI; privatization programmes are often open to foreign investors; foreign equity participation restrictions and compulsory joint ventures have been removed in most industries open to private investment; screening and authorization requirements tend to be replaced by simple registration on the basis of minimum and generally applicable requirements; and a number of other steps reducing obstacles to and creating more favourable conditions for FDI are being increasingly adopted (UNCTAD, 1999b: 174-175). In more countries and sectors however, increased barriers have been raised – natural resources and M&As in some countries recently.

Notwithstanding the trend towards regulatory liberalization, many host developing countries still have requirements regarding permits, licenses, approvals, and so on that are needed in order to invest and operate over time. Administrative barriers can discourage foreign (and domestic) investors, raising transaction costs of investment and operations significantly. In contrast, "best practice" administrative systems directly related to FDI that are clear, simple, fast and efficient can encourage FDI.

Liberalization and heightened competition for FDI among host countries have increased the importance of proactive measures to attract FDI (Module 1, theme 3; Module 2, theme 1). These include investment promotion through image building, dissemination of information, positive inducements through financial, fiscal or other incentives, after-investment services (including reducing the "hassle costs of doing business"), and targeting specific types of investors. Such proactive measures, along with an enabling policy framework and an effective administrative system, can help attract FDI, to supplement and complement domestic resources and investment, provided the necessary economic conditions are present.

Attracting FDI is only one part of the goals of national FDI policies. Making sure FDI exerts a positive impact on the host country and reaping as much benefit from it as possible is the other side of the coin. Box 17 elaborates on this looking at the case of extractive industries.

To complement and strengthen national policies and measures to enable and attract FDI inflows, countries can participate in international investment agreements at various levels. Developing countries have concluded a large number of bilateral treaties for the promotion and protection of FDI and the avoidance of double taxation. They also participate in increasing numbers in regional integration agreements that provide for liberalization of FDI policies (Module 2, theme 2). In addition, most developing countries are parties to a number of multilateral conventions dealing with investment issues such as the International Centre for Settlement of Investment Disputes (ICSID), the Multilateral Investment Guarantee Agency (MIGA), the WTO Agreements on Trade in Services, Trade-Related Investment Measures (TRIMs) and Trade-Related Aspects of Intellectual Property Rights (TRIPS).

Box 17

Governance and regulation to maximize development gains from FDI in extractive industries

The quality of government policies and institutions is a determining factor for ensuring sustainable development gains from resource extraction, with or without TNC involvement. The management of a mineral-based economy is complex, and requires a well-developed governance system and well-considered national development objectives. In some mineral-rich developing countries, however, government policy-making may be aimed at short-term gains rather than long-term development objectives. Furthermore, the distribution and use of a host country's share of mineral revenues may be determined with little attention to development considerations. In some cases, easy access to revenues from mineral resources can make governments less accountable to their populations, and more inclined to preserve and extend the interests of a small governing elite.

These factors underline the importance of developing a legal system based on the rule of law, as well as an institutional environment in which companies have incentives to invest in productive activities. Moreover, proactive policies aimed at using government revenues from extractive industries to achieve development goals are essential for ensuring social cohesion; indeed, large increases in revenues can cause social disruptions and political instability if they are not channeled and managed carefully. Beyond the overall framework, appropriate sectoral institutions and policies are needed, including a legal and administrative framework for

Box 17

Governance and regulation to maximize development gains from FDI in extractive industries

the exploration and exploitation of minerals, for health and safety, and for the protection of the environment and the rights of local communities.

In this policy-making process, all relevant stakeholders – governments, civil society, affected communities, indigenous peoples' organizations, labour unions, industry and international organizations – must be given a chance to participate in order to avoid inequitable outcomes. Allocating an acceptable share of the revenues to provincial and other lower levels of government can be a way to mitigate social conflicts in the local areas most directly affected by extractive activities. However, this also requires adequate governance systems and capabilities at the local-government level.

The way foreign involvement in extractive industries is governed has changed over time and still varies considerably by country. Approaches range from total prohibition of foreign investment in resource extraction (as in the case of oil in Mexico and Saudi Arabia) to almost complete reliance on TNCs (as in the case of metal mining in Ghana and Mali, or oil and gas extraction in Argentina and Peru). Various national laws, regulations and contracts govern TNC involvement. In addition, many countries have entered into IIAs of relevance to the operations and impacts of extractive-industry TNCs.

In the oil and gas industry, TNCs operate under contractual arrangements of various kinds, such as concessions, joint ventures, production-sharing agreements (PSAs) and service contracts. Overall, as of June 2007, PSAs were the most commonly used form, accounting for more than 50 per cent of all contracts with foreign TNC participation in the main oil- and gas-producing developing economies. They were the main contractual form in countries such as China, Equatorial Guinea, Indonesia, Iraq, the Libyan Arab Jamahiriya, Qatar, Sudan and Viet Nam. Concessions and joint ventures are the next most commonly used contractual forms, and the dominant ones in Algeria, Angola, Brazil, Kazakhstan, the Russian Federation and Venezuela. Service contracts are less common but are important, for example, in the Islamic Republic of Iran and Kuwait.

In both the oil and gas and the metal mining industries, the evolving arrangements reflect an ongoing process through which governments seek to find an appropriate balance between the respective rights and obligations of States and firms. As government revenue is among the most important benefits from mineral extraction, it is not surprising that policymakers devote much attention to finding a mechanism that assures the government an appropriate share in the profits from mineral extraction. As the result of higher mineral prices in the past few years, a number of governments have taken steps to increase their share of the profits generated by amending their fiscal regimes or their contractual relations. Recent regulatory changes in developed, developing as well as transition economies suggest that many governments believed their previous regulations may have been overly generous *vis-à-vis* foreign investors.

Source: Based on UNCTAD (2007: xxv-xxvii).

3 Enhancing technological capabilities

Transforming and upgrading technologies used in production and strengthening national technological capabilities, including the capacity to innovate, is a key requirement for economic growth and development. It leads to the introduction of new and better products and new production processes that raise productivity and lower the costs of production, thereby contributing to sustained growth in output and income. The transfer of technology, its efficient application and diffusion are therefore some of the most important benefits sought by developing countries from FDI.

TNCs tend to be leaders in innovation. They are leading suppliers of technology to developing countries and economies in transition, through FDI and other (non-equity) forms of transfer. They can also undertake innovative activities and stimulate the development of innovative capacities in host economies, thereby supplementing technology development that takes place through R&D in domestic firms and publicly funded institutions.

3.1 Technology transfer

Leading innovators in an industry are often TNCs. They transfer their technologies internally, through FDI, to their foreign affiliates. They may also transfer them to other firms through externalized modes of transfer such as licensing, subcontracting, strategic alliances or sale of capital goods.

The technologies that TNCs transfer to their foreign affiliates are generally more modern and productive than those available in host countries, especially developing and transition economies (UNCTAD, 2000: 173). However, the nature of the technology or process transferred reflects both the conditions in the host economy (wages, skills, supply capabilities, scale, and so on), host country policies (intellectual property rules, rules on technology transfer, etc.) and the motivations of the TNCs concerned. Affiliates in advanced host countries receive complex technologies, while less developed ones receive simple technologies and processes. Nevertheless, the transfer can enable a host country to expand its productive base and use a larger range of technologies.

Many technologies, especially the latest and most valuable, are available only through FDI. These are generally new, valuable technologies (based on expensive R&D, integral to branded products) that firms are unwilling to make available to unrelated parties. Even where they are available through externalized forms of transfer (licensing, other types of contractual arrangements, or arm's length sale of technology embodied in goods), internalized transfer can have several advantages for the recipients and hence, the host countries (UNCTAD, 1999b: 207-209):

- Internalized transfer is often a cheaper and quicker mode of transfer. Where the technology involved is very large-scale, foreign investors are often able to mobilize the resources needed more efficiently than local firms. Where the buyer is likely to become a competitive threat, firms charge external buyers high prices for new technologies, provide only older vintages or impose conditions to protect their markets (e.g. export restrictions, prohibition of sub-licensing, ban on local improvements).

- Where technologies change rapidly, repeated contracting may be cumbersome and slow, leading to high costs or technological lags. Internalized modes allow foreign affiliates to have access to technologies generated by their parent firms, although the extent to which they actually have access depends on the parent firms' strategies and the affiliates' capabilities. In general, foreign affiliates tend to be at the forefront of introducing new management and organizational techniques, quality management standards, training methods and marketing methods.

- The most important benefit of internalized transfer, however, is that it provides foreign affiliates access, at least in principle, to the whole range of technological, organizational and skill assets of TNCs operating in a host country, including their tacit knowledge. This is an important consideration where the use of transferred technology requires capabilities superior to local capabilities in a host country. In such a situation, the efficiency of the transfer depends on how the recipient firms cope with the learning process and foreign affiliates can have lower learning costs and shorter learning periods than local firms in contractual arrangements. Foreign affiliates can draw upon the resources of their parent firms for the skills, information, experience, tacit knowledge and finance needed to absorb and adapt the technology to a new environment. Parent firms may charge affiliates for services provided, but the marginal costs are likely to be low in relation to those of a local firm that has to create the skills, knowledge and structures needed from scratch.

- Internalized transfers can provide other benefits besides technological learning. TNCs' marketing skills and brand names make it easier to commercialize new technologies within the host economy or abroad. If a transfer is part of an export-oriented operation, the affiliate gains access to regional or global markets or to an integrated international network of the parent company (see section 4). Internalized transfers can also lead to similar transfers by other TNCs in vertically linked activities.

- Internalized transfer of technology can have disadvantages as well, however, for both, the firms (foreign affiliates) that receive the technology and the host countries concerned (UNCTAD, 1999b: 209).

- When transfer is internalized, payment is made by the host-country recipient (the foreign affiliate) not just for the technology acquired but for the whole FDI package including the TNCs' brand names, finance, skills and management. Where local firms possess the capability to use the technologies efficiently and do not need the other assets, this can be more expensive than externalized transfer, assuming that the technology is available through externalized modes. For technologies readily available on license or through other non-equity modes such as strategic inter-firm technology alliances, and in countries with relatively well-developed entrepreneurial and technological capabilities, externalized modes are likely to be cheaper.

- A more important drawback of technology transfer through FDI is the control by TNCs of the technologies they transfer, as the technologies figure among their key ownership advantages. While their efficient internal markets for skills and knowledge make it easy to use new technologies inside their corporate systems, this process can hold back deeper learning processes and spillovers in the host economy. There is likely to be less effort to absorb, adapt, improve, or utilize innovative technology in affiliates than would be the case when local companies acquire technology on license or buy equipment. In the short term, an affiliate may be more efficient in acquiring and implementing a given technology but, in the long term, it may develop fewer innovative capabilities than a local counterpart.

Some developing countries, such as the Republic of Korea and Taiwan Province of China, have relied successfully in the past on externalized transfers of technology in building up their technological capabilities (box 18). Many other countries that have tried to encourage unpackaged transfer of technology have, however, been less successful in developing internationally competitive technological capabilities (UNCTAD, 1999b: 210). With the rapid pace of technological change and increased competitive pressures due to globalization, and given the advantages of internalized transfer mentioned above, FDI may often prove to be both easier and cheaper as a long-term means of technology transfer. However, given that the technologies transferred by TNCs to their affiliates in host countries are geared to local capabilities and existing comparative advantages, policies and measures to induce TNCs to improve the content of the technology transfer are important. Policies to strengthen the skills, technological capabilities, supplier networks and infrastructure of host countries are particularly important.

Box 18

Externalized transfers of technology: experience in two Asian economies

Some of the economies that succeeded most in building up domestic technological capabilities – the Republic of Korea and Taiwan Province of China for example – did so by relying mainly on externalized technology transfer. Nevertheless, local firms often had long-term relations with TNCs in the form of subcontracting or original equipment manufacture contracts. They also encouraged the absorption of imported technologies in a strongly export-oriented setting, thus forcing local firms to develop and deepen their own technological capabilities (Lall, 1995; Ernst *et al*., 1998). As firms became internationally competitive and needed more sophisticated products, they found that externalized transfers were insufficient. The latest technology was often simply not available from the innovators – they had to import technology either by going into other arrangements (franchising or original equipment manufacture) and/or by investing in their own R&D to imitate and build upon foreign technologies. Some firms became outward investors to engage in alliances with, or take over, innovative firms abroad or to establish listening posts in industrial countries. The process of restricting inward FDI while encouraging local capabilities to absorb TNC technologies required the rapid build-up of strong R&D capabilities. In the Republic of Korea, for example, R&D capabilities were developed in the large chaebol fostered by the government; in Taiwan Province of China, largely populated by smaller firms, the authorities themselves also played a role in R&D.

Source: UNCTAD (1999b: 209); Lall (1995); Ernst *et al.* (1998).

3.2 Technology diffusion

The transfer and use of new technology to the TNCs foreign affiliates is only one aspect of the contribution that FDI can make towards strengthening the technological capabilities of host countries. Another, often larger benefit is the diffusion of technology and skills to people and domestic firms within the host economy. Much of this diffusion takes place in the form of spillovers or externalities that arise involuntarily or result from actions deliberately undertaken to overcome information problems.

Positive spillover effects leading to the diffusion of technology and skills from foreign affiliates to a host economy may occur through four channels:

- Competition with local firms, stimulating the latter to improve efficiency and technological capabilities and raise productivity.
- Cooperation between foreign affiliates and local suppliers, customers and institutions with which they have linkages, leading to information exchange and technical collaboration that enhance the technological capabilities of the linked local agents.
- Labour mobility, particularly of highly trained personnel, from foreign affiliates to domestic firms including supplier firms set up by former TNC employees, often with the support of their former employers.
- Proximity between foreign and local firms, leading to personal contact, reverse engineering, imitation and the formation of industrial

clusters facilitating technological upgrading in host countries.

The scope for positive spillovers varies according to host-country conditions and the strategies of TNCs with respect to their FDI. For example, whether competition stimulates existing local firms to improve efficiency and productivity depends on the initial difference between affiliate and local firm technological levels as well as the learning costs involved in bridging the gap and the level of capabilities of local firms. If the gap is too large, existing (and potential) firms in host countries may decide to move to (or stay in) less demanding activities or end up as suppliers to TNCs. Furthermore, spillover effects through competition can be adverse if TNCs deliberately raise concentration levels, forcing competitors out of business by predatory practices, poaching skilled labour or R&D staff from local firms, or engaging in restrictive business practices (RBPs). The risk of such behaviour is greater if a country lacks efficient competition policy tools and skills.

Linkages between foreign affiliates and local firms, particularly suppliers, are an important potential channel for technology spillovers. TNCs invest in building up the technological capabilities and skills of suppliers to their foreign affiliates as long as the costs of doing so are lower than the resulting savings. But the scope for this depends on the extent to which TNCs build up linkages in host countries, which depends significantly on local capabilities and on information regarding those capabilities. TNCs generally tend to rely on foreign suppliers in the initial stages of their FDI in a host country but switch to local suppliers over time, provided there are potential local suppliers with the necessary technological capabilities. Once foreign affiliates establish linkages with local suppliers, they often invest in helping the latter upgrade their technological capabilities and skills (see box 19 for an example). This generates positive spillovers to the extent that the capabilities of suppliers improve beyond the extent needed for supplying foreign affiliate operations.

Box 19

FDI and technological upgrading in host-country enterprises – an illustration

The Aditya Birla Group is one of India's top TNCs. It has 72,000 employees worldwide and manufacturing units in Australia, Canada, China, Egypt, Indonesia, Malaysia, the Philippines and Thailand. In 1994 the company established the Alexandria Carbon Black (ACB) factory in Egypt. Owing in part to continuous product and process innovation, the ACB plant has grown to become one of the world's largest carbon black plants.* The ACB plant has a sophisticated R&D centre with the latest analytical equipment. It employs 300 persons, out of whom 25 work in its R&D centre.

ACB provides various forms of technical support to domestic enterprises. Local companies can use its analytical equipment. ACB provides training to employees of local companies, including on best practices in quality management, how to use sophisticated analytical equipment, statistical quality control tools and total productive maintenance. In order to upgrade the skills of the employees of its suppliers, the company also offers technical and managerial support.

Some development work (e.g. related to improvements in raw material and packaging) has also been done in partnership with suppliers. Six major partnerships with suppliers have been forged in the areas of packaging, raw materials and manufacturing of sophisticated equipment. As a founding member of the Regional Geographical Committee of the Petro-Chemical Area, ACB also helps the adoption of best practices by local companies.

ACB's R&D centre is closely collaborating with the parent company's Fundamental Research Institute in India. The Aditya Birla Group provides significant support to ACB in a number of areas, and members of ACB's technical team frequently travel to other carbon black units of the group to exchange experiences and learn from the others.

Source: UNCTAD (2005: 151).
Note: Carbon black is a key raw material input mainly for the manufacture of tires and other rubber products.

The best way to raise linkages between TNCs and local firms and thus, the prospects for positive spillovers is to strengthen the capabilities of local suppliers. These supply side measures are preferable to local content requirements, which (like other measures to promote one set of enterprises) can be detrimental to efficiency. Examples of such measures are found in Singapore and Taiwan Province of China, which have focused on providing strong technology support services to SMEs, generally with the support of TNCs (UNCTAD, 1999b: 212). Other countries have put emphasis on developing strong clusters and networks of local enterprises, and assisted them in building technological capabilities.

3.3 Technology generation

As TNCs are often leading innovators, to the extent that they locate their R&D activities in host countries, FDI has the potential to increase technology generation and strengthen innovatory capacities in host countries. However, because R&D is a strategic function for them, TNCs tend to centralize R&D in their home countries and to locate it abroad only in a few other countries, mainly industrialized ones so as to reap economies of scale and linkages with technology and research centres.

Developing countries attract only small shares of foreign-affiliate research and what they do attract is concentrated in a few countries and is related to production (adaptation and technical support) rather than radical innovation. The majority of developing countries do not have the research skills or institutions to make it economical for TNCs from developed countries to set up local R&D facilities. In some countries that do have well-developed local research capabilities, such as the Republic of Korea, there has been relatively little R&D by foreign affiliates because of policies which for some time restricted the entry of TNCs and promoted technology development by externalized forms of technology transfer. Some others, such as Brazil have much larger foreign-affiliate R&D spending, in the case of Brazil partly because of R&D capacities acquired by TNCs as a result of M&As in that country (UNCTAD, 1999b: 216). Judging from data on R&D by affiliates of US TNCs, in the mid-1990s, only 8 per cent of foreign affiliates' R&D was located in developing countries, and over three quarters of that was in Brazil, Mexico, Singapore and Taiwan Province of China (UNCTAD, 1999b: 215).

There is evidence that the picture is changing, however (UNCTAD, 2005: chapter IV). More developing countries and transition economies are now attracting R&D by TNCs, including some highly advanced R&D activities. In a number of cases, these activities are geared to production for global markets and are being integrated into the core innovation networks of TNCs (box 20). A major factor driving this trend is the growing availability of educated and highly trained human resources in a number of developing countries.

Box 20

R&D internationalization and technology generation in developing countries

Although few developing countries have traditionally attracted R&D activities by TNCs, thanks to strategic investments in education and in other parts of the innovation systems, this is now changing.

More than half the world's top R&D spenders already conduct R&D activities in China, India or Singapore. Since the early 1990s, when Motorola established the first foreign-owned R&D lab in China, the number of foreign R&D units in China has grown to some 700. In India, the R&D activities of General Electric employ 2,400 people in areas as diverse as aircraft engines, consumer durables and medical equipment, and most global pharmaceutical companies now run clinical research activities there. Starting at practically nothing in the mid-1990s, South-East and East Asia now account for 30 per cent of all semiconductor design in the world. When Toyota decided to establish its fourth overseas R&D centre, it chose Thailand. STMicroelectronics, one of the world's largest semiconductor companies, has located some of its design work in Morocco. The number of such examples is rising.

The trend towards R&D internationalization is set to continue. The competitive pressure on firms is likely to remain intense, forcing them to innovate even more, and at lower costs. Moreover, rapid technological change in some industries increases the need for flexibility in R&D, which in turn requires access to sizeable numbers of researchers with a range of specializations. Such pools of talent are increasingly found in emerging economies. For example, China, India and the Russian Federation now account for almost a third of all tertiary technical students in the world. Ageing populations in developed countries may further accentuate the need of firms to look elsewhere for research staff. Furthermore, through cumulative learning processes involving local enterprises and institutions, the developing countries that take part in the internationalization of research activities should progressively enhance their own capabilities to engage in R&D.

While the share of developing countries in the global R&D networks of TNCs is rising, it is doing so unevenly. Only a small number of developing countries and economies in transition are participating in the process of R&D internationalization. But the fact that some are now perceived as attractive locations, even for highly complex R&D, shows that it is possible for countries to develop the capabilities needed to connect with the global R&D networks of TNCs. R&D internationalization opens the door not only for the transfer of technology created elsewhere, but also for the transfer of the actual process of technology creation. That means new

Box 20

R&D internationalization and technology generation in developing countries

opportunities for firms and institutions in developing countries to engage in important learning processes. It also creates new job opportunities for skilled engineers and scientists in the countries involved, helping to mitigate the risk of brain drain.

Source: UNCTAD (2005: xxiv-xxviii).

3.4 Conclusion and policy implications

The transfer and diffusion of new and improved technologies and the strengthening of technological and innovatory capabilities are probably the most important contributions FDI can make to host-country development. The impact of FDI in these respects depends, however on technological and other capabilities in the host economy, particularly the education and skill levels of human resources, the technological capabilities of domestic suppliers and other linked firms, and the strength of local technological institutions. It also depends on the competitiveness of the host-country environment. The higher the level of local capability and the more competitive the environment, the better the quality of the initial transfer. The more rapid the development within foreign affiliates, the greater the diffusion of technology to linked enterprises and others, and the greater the prospects for attracting R&D by TNCs.

Governments can influence the quality of technology transfer through policies to attract FDI into high technology industries. Such policies can include, among others, targeting specific industries for FDI, offering incentives to FDI projects whose products or processes are new to the country, offering incentives to existing foreign investors to move into more complex technologies and to increase R&D undertaken locally, developing industrial parks with high quality infrastructure to attract high technology investors, improving the skills and training base, and collecting, organizing and disseminating information about the technical, research and training facilities in the host country (UNCTAD, 1999b: 223-224).

Specific measures can be implemented to enhance technology diffusion by raising linkages between TNCs and local suppliers, including SMEs. These include policies such as encouraging technology alliances between local firms and TNCs by offering fiscal benefits for R&D or exploitation of its results; improving extension and training services to strengthen the capabilities of SMEs; developing backward linkage programmes between TNCs and domestic suppliers; providing venture capital to encourage TNC employees and others to establish enterprises that tap the skills and technologies developed by TNCs; adopting effective competition policies to stimulate efficient domestic competition; and providing or enhancing the performance of the technology infrastructure (UNCTAD, 1999b: 225-226).

Measures can also be taken to encourage local R&D by TNCs. These may include encouraging contract R&D with local research institutions and universities; developing human resources for R&D in specialized disciplines by supporting local universities and other institutions of higher learning and adapting their curricula; developing university research labs and research institutes; offering incentives for foreign affiliates to obtain "product mandates" from parent companies and to undertake local R&D more generally; accelerating technology generation by enforcing intellectual property rights; and supporting local innovation systems through strategic planning regarding a country's future technological development (UNCTAD, 1999b: 226-227).

National policy efforts regarding the transfer, diffusion and generation of technology in host countries can be complemented by international measures and cooperation. In designing such measures and cooperation, some elements that could be taken into account include: examining the policies and incentive structures that technology supplier countries could implement to encourage the transfer of technology to developing countries, taking into account the tax and incentive policies that a number of home countries have already introduced with this objective in mind; and defending the interests of both creators and users of technology by maintaining an appropriate balance between the incentives to innovate and the need for adequate diffusion of technical knowledge among firms and countries, and by introducing safeguards to prevent abuse of intellectual property rights (UNCTAD, 1999b: 227).

4 Boosting export competitiveness and trade

International trade can influence economic development in a number of ways. It allows countries to benefit from economies of specialization in accordance with comparative advantage. Exports help developing countries overcome the constraints of small domestic markets, and generate foreign exchange needed for importing capital goods and technology essential for investment and productivity growth. Exports also enable learning from experience in export markets.

That trade has positive effects on growth and development has not always represented the dominant view. Advocates of infant industry protection have argued in favour of limiting trade flows in order to develop domestic industries. This view has had support in developed as well as developing countries; practically all industrialized countries of significant size have gone through an import-substituting phase that allowed them to reap economies of scale and greater degree of technical efficiency through learning by doing which eventually transformed them into exporters of manufactures (UNCTAD, 1999a: 29-30). This is the classical argument for infant industry protection. Many developing countries have pursued import substitution strategies as well. However, given the heavy dependence of most developing countries on trade, as well as the difficulties encountered in implementing import-substitution efficiently, there is now widespread agreement on the potential benefits of engaging in trade while building up local capabilities to compete with imports and strengthening export competitiveness. Trade liberalization has been widespread.

FDI and TNC activities can help developing countries exploit existing comparative advantages in international trade and build new ones. Many TNCs are motivated by resource-seeking and efficiency-seeking considerations that lead them to invest in export-oriented activities in host countries. TNCs account for a large share of world exports and imports. Their role is greater in trade in technology- and skill-intensive industries, the most dynamic and high value-added activities and these increasingly include tradable services as well as manufacturing.

TNCs are increasingly setting up integrated production systems across countries, with considerable specialization among geographically dispersed units by technology level and labour costs; thus, intra-firm trade plays an increasingly important role in trade, especially in some of the most sophisticated products. TNCs are also very active in the extraction and exploitation of natural resources and production of resource-based manufactures for export from developing countries, and in relocating simple labour-intensive activities and processes (including within high technology industries) in developing countries for export-oriented manufacturing.

Thus, FDI can help host countries raise exports in all kinds of industries by providing the missing elements, tangible and intangible, that are needed to compete in international markets or by improving the local base of skills and capabilities. However, the impact of FDI on strengthening host countries' export competitiveness is not unambiguously positive: much depends on the nature of local skills and capabilities and on measures taken to improve these over time.

At the same time, inward FDI also affects the volume and composition of host-country imports. It has been found, in most cases, to lead to a net increase in imports (UNCTAD, 1996: 73-85), adding to both arm's length and intra-firm purchases of goods and services. Some of these imports serve to complement domestic comparative advantages and strengthen export competitiveness. The composition of host-country imports also tends to change, as production by foreign affiliates is often more technology intensive than domestic production. The economic implications of increased imports due to FDI depend on the quantity, quality and prices of foreign affiliates' products.

4.1 Impact on export competitiveness

The main effects of FDI on the export competitiveness of host countries arise from their role in exploiting the static comparative advantages of host countries, building dynamic comparative advantages, providing access to international markets, and raising local links to export markets (UNCTAD, 2000: 190-191).

Exploiting static comparative advantages. FDI can be an effective means of providing the missing resources, such as the skills, training and technology, capital goods and intermediate inputs needed to exploit host countries' existing comparative advantages. In developing countries, these advantages may be natural resources and low-wage unskilled labour in less developed countries, or the base of capabilities built up earlier (often behind protective barriers under import-substituting regimes) in more advanced ones. FDI may not, however, be sufficient to sustain export growth as wages rise and it becomes necessary to develop more skill intensive and technology intensive exports. TNCs can improve worker skills, but cannot upgrade the local base of education and capabilities. Unless the host country does this, there is a danger that TNC-based export growth will peak and then stagnate.

Creating dynamic comparative advantages. In host countries with adequate education and capabilities, TNCs can help create dynamic comparative advantages by means of new skills and advanced technologies introduced through their foreign affiliates' production activities. This has been the case, for example, in some countries of South-East Asia (box 21). In countries with more advanced industrial and technology bases, TNCs can feed into innovation by setting up R&D centres and interacting with local research.

Box 21

Building up dynamic comparative advantage with the assistance of FDI: the case of Malaysia

Malaysia provides a good case of a TNC-assisted build up of dynamic comparative advantage and also illustrates the limits to such a process. Electronics TNCs originally invested in simple labour-intensive operations in that country to take advantage of cheap, disciplined, semi-skilled, English-speaking workers, good infrastructure and attractive incentives (Lall, 1998). The operations were isolated in export enclaves with practically no domestic supply or technology linkages. As wages rose, technologies changed and the government applied pressure to increase local capacity and deepen technology levels. Electronics TNCs responded by automating assembly processes, bringing them to levels used in high wage countries (Hobday, 1996; Rasiah, 1995). They invested massively in increasing worker's skills (Intel's facility is referred to as "Intel University") and sent high level staff overseas for extensive training. They convinced their international suppliers to set up affiliates in Malaysia and helped local firms (still relatively few) to develop supply capabilities. The technological content of affiliates rose as they were assigned some process and product design work. At the same time, low technology foreign investors in garments (and large local garment manufacturers) started to wind down assembly operations in response to rising wages. Several shifted their most labour-intensive operations to neighbouring low-wage economies such as Vietnam.

This being said, Malaysia still suffers from a scarcity of individuals with high-level technical and engineering skills. Despite more engineering courses in universities and sending students overseas, the number of engineers and technicians (relative to the size and sophistication of the industrial sector) lags well behind that in economies such as Singapore, the Republic of Korea, Taiwan Province of China or the Philippines. The country allows liberal use of expatriate engineers and technicians, but human capital shortages are a major constraint on further technological upgrading.

Source: UNCTAD (1999b: 248); Hobday (1996); Lall (1998); Rasiah (1995).

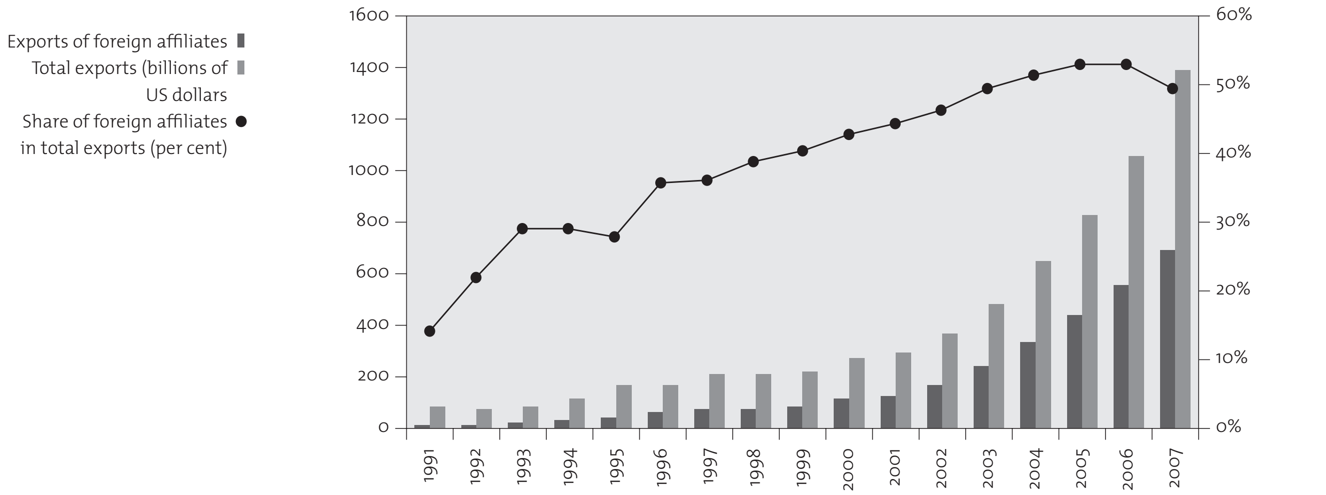
Providing access to international markets. Successful exporting needs not only competitive products but also marketing expertise and access to international markets. FDI can provide a major benefit in this respect, especially in markets in which established brand names and large distribution networks are important assets. Where trade is internal to TNCs, as in some high technology products, joining TNC networks is often a necessary condition for increasing exports. On the other hand, foreign affiliates may have less freedom than domestic firms to choose export markets and diversify their product range. Those assigned to the low end of the value-added chain may stagnate relative to competent and technologically progressive local firms.

Increasing local firms' links to international markets. To the extent that a foreign affiliate sources inputs locally, FDI in export-oriented industries links domestic suppliers indirectly to international markets. These enterprises may later be able to exploit these links further on their own. With trade liberalization, foreign affiliates' decision to source their inputs locally or abroad is subject more to cost and delivery considerations than to host-government trade policies. As noted, when they first enter a host country, TNCs may tend to use overseas suppliers with whom they have strong linkages, however, there are advantages to having suppliers nearby and TNCs invest in developing local suppliers when the cost of building their capacity to the necessary technical and quality levels is modest. Some of this takes place through FDI in supplier industries including producer services. Over time, linkages with local firms increase, creating opportunities for local supplier firms to expand sales not only to export-oriented foreign affiliates in host countries but to venture directly into international markets.

Statistical analysis suggests a positive link between FDI and export performance in manufactures (UNCTAD, 1999b: 245-247). The relationship is stronger for developing than for developed countries as well as in high rather than low technology activities. The data thus suggest that there is a correlation between FDI and export dynamism in the developing world, at least in a cross-section sense. However, export-oriented TNC operations in manufacturing in developing countries are concentrated in a few countries, and high-technology networks of TNC trade extend to an even smaller number. Only four of the 15 countries in which foreign affiliates accounted for more than 20 per cent of total exports of manufactures in or around 1999 were developing countries (Argentina, China, Malaysia and Mexico) (annex, table 6). Among these, China provides a particularly noteworthy example of a country in which foreign affiliates have played an important role in the growth of exports (figure 19). The reasons for the differences in the contribution of foreign affiliates to developing country exports relate to firms' strategies and host country conditions, including comparative advantages as well as local capabilities influencing competitiveness, and policy factors.

Figure 19

Share of foreign affiliates in China's total exports, 1991-2007



Source: UNCTAD FDI/TNC database.
Note: Exports of goods and services.

Exports by foreign affiliates do not fully reflect the role of FDI and TNC activity in countries' exports. Non-equity forms of TNC participation can play an important role in boosting exports. In addition to contractual arrangements for the transfer of technology that may be needed for developing export competitiveness, franchising or licensing the use of TNCs' brand names can boost export capabilities considerably. TNCs allow independent firms to sell under their brands, under OEM arrangements, as in electronics, or under international subcontracting such as in clothing. OEM in electronics has been confined to a few newly industrialized economies with strong local capabilities, mainly the Republic of Korea and Taiwan Province of China. Subcontracting simple products like clothing is more common, and here foreign buyers offer an alternative way of overcoming the costs of exporting.

4.2 Conclusion and policy implications

FDI can play an important role in strengthening export competitiveness in host developing countries. It can help exploit existing comparative advantages, build new comparative advantages, and enhance access to international markets directly as well as through linkages with local firms. Its role differs among host countries, depending on the resources, capabilities and conditions relating to competition in the host economy.

Evidence suggests that foreign affiliates are significant exporters only in a relatively small number of developing countries. The potential role of TNCs to upgrade export competitiveness in the new global context of liberalization and technological change can be exploited more fully through supportive domestic and international policies. Some of them are discussed below.

Policies directed at boosting export competitiveness need to examine the best ways of exploiting export markets for traditional commodities as well as to anticipate emerging opportunities. For commodities, resource-rich economies might examine policy measures to bring more value-adding activities to the host country, for example by targeting FDI in trade or marketing. With respect to services, governments need to examine which parts of the increasingly segmented value chains they might be able to capture as TNCs disperse tradable services among different locations. They can also target FDI in tourism, health or educational services.

With respect to export competitiveness in manufacturing, the area of greatest interest to most developing countries, policy issues will differ according to the different stages of technological and industrial development of host countries (UNCTAD, 1999b: 251). For countries with weak industries and low export growth, issues are centered on their ability to attract FDI and to stimulate industrial growth in general so as to step into export-oriented activities in low technology areas, becoming uncompetitive in more advanced countries. For countries that have attracted FDI into low technology export activity but have failed to diversify or move into higher value products, the main issues relate to how to broaden the competitive base and upgrade exports. For those that have entered high-technology production and exports with the assistance of TNCs, the issues relate to sustainability and upgrading TNC activities as wages rise and cheaper competitors appear. Lastly for countries with strong national innovation systems and exports led by national enterprises, the main issues relate to whether to assign a role to TNCs and how national enterprises should relate to TNCs, i.e. as competitors and/or potential collaborators.

In all groups of countries, policy-related essential preconditions for attracting and benefiting from FDI in terms of export competitiveness relate to prudent macroeconomic management – especially of the exchange rate – and an institutional environment conducive to exporting, including the provision of trade-related physical and institutional infrastructure. Policies and measures must also address the common issues of liberalizing FDI and trade regimes; attracting export-oriented FDI and upgrading TNC activity; and strengthening domestic skills, capabilities and institutions. Each of these has a vital role to play in realizing the potential of FDI to generate and upgrade exports. The precise nature of problems to be tackled and measures to be used will differ, however, according to the level of national capabilities and development, the nature of the policy regime and the form of participation in TNC networks (UNCTAD, 1999b: 252).

Liberalization of trade and FDI policies. In the context of globalization it is generally advisable for countries to deepen their integration into the world economy in the areas of international investment and trade. While liberalization has been widespread, not all countries have adopted full fledged liberalization of trade and FDI. In such cases, selective liberalization through measures such as export processing zones (EPZs), or a policy of "trade neutrality" may be considered.

Measures to attract export-oriented FDI. This requires targeting investment conducive to export competitiveness and upgrading. Where an Investment Promotion Agency exists, it could gear some of its activities to this objective. A special effort could be made to draw FDI into industries in which a country has a revealed comparative advantage, that is, where its exports of a product are growing faster than world exports. If this can be combined with attracting TNCs that have a competitive edge in that product and in world trade, a virtual cycle could be generated. Targeting initiatives could also seek out (emerging) TNCs from developing countries that are active in export niches or as specialized suppliers to global exporters.

Measures to strengthen domestic capacity. Regardless of the role played by FDI in export activity, strengthening domestic enterprises as well as the skills, capabilities and institutions on which they rely is probably the single most important element for successful export promotion in the long run.. Measures can be taken to support local export-oriented industries that can serve as a magnet for FDI and for nurturing efficient supplier networks. Governments can, for example, initiate training programmes for domestic companies to upgrade their product quality and productivity or enlist the assistance of TNCs engaged in the export sector for this training. Targeted incentives for creating specific skills required by particular export industries are another possible measure. Developed as well as developing countries have used local content requirements which are subject to provisions of the Agreement on Trade-Related Investment Measures and are required to be phased out to encourage the creation of backward linkages and to increase the share of value added in the host economy. They have also used export performance requirements to encourage the export orientation of foreign affiliates.

Host-country policies to strengthen export competitiveness and enhance the contribution of FDI in that respect need to be supplemented by measures in importing countries to expand market access by liberalizing rules governing trade in products of particular importance to developing countries. In a broader context, an efficient rule-based multilateral trading system is of critical importance for developing countries seeking to boost their export competitiveness. Membership in the WTO and the ability to follow up on implementation of its rules is important since a number of policy instruments of the organization (contained in TRIMs) have a bearing on the impact of FDI on export competitiveness and upgrading.

5 Generating employment and strengthening skills

Employment, employment quality and the skills of workers are linked to development in several ways. Increasing the quantity of labour employed in productive activity generally contributes to increasing output and income in an economy. If the increase in employment is in higher value-adding sectors of the economy, there is also an increase in the average value added per employee, generally leading to rising wages and improved conditions of work. Furthermore, employment creation and upgrading are important means for countries to achieve an equitable distribution of income and minimum standards of welfare for their people. Thus, for all countries, reducing unemployment, moving towards full employment and moving towards higher value-adding sectors are critical components of development. In developing countries, where public support mechanisms for the poor and unemployed are often lacking, these processes are particularly important.

FDI and international production play a role in the generation and upgrading of employment and building capacity in the host countries in which TNCs operate. The role of FDI and its impact vary according to the type or motivation of FDI, the industries in which TNCs invest, the strategies they adopt and host-country conditions. They also depend on host-country policies directed towards increasing employment quantity, improving employment quality and strengthening human resource capabilities and minimizing any negative effects that FDI might have in these respects.

5.1 Employment generation

For all enterprises, domestic or foreign, the technological parameters of an industry (e.g. in terms of labor intensity) determine, to some extent, the employment-generating potential of their activities. Given those parameters, TNCs differ from other firms in that they distribute their employment in different locations. The largest TNCs generate substantial volumes of employment in host countries at a global level (annex table A.2). The distribution of employment by size and quality among different locations depends upon the TNCs' motivations for and strategies with respect to international production and the locational advantages of different countries, including those related to the availability and cost of labour of various skills and capabilities.

While FDI of all types involves employment in host countries, some FDI is motivated specifically by considerations related to the employment of skilled or unskilled labour. Efficiency-seeking FDI in manufacturing and services is often made with the specific objective of accessing low-cost labour for labour-intensive production or taking advantage of relatively abundant supplies of educated and skilled workers. For market-seeking FDI, accessing labour is not the main consideration, although it is likely to be one of the secondary factors that determine investment location.

Given the broad motivations, the strategies and resulting organizational structures of TNCs' international production strategies affect the employment-generating potential of FDI in host countries. Foreign affiliates established under a "stand alone" strategy, in which a TNC replicates much of the value chain of the parent in the affiliates, are likely to generate more employment, given the size of the market and the firm, than those established for efficiency-seeking motivations. Employment is also likely to be more stable in stand-alone affiliates, since FDI is motivated by market size rather than labour cost advantages that might be relatively short lived. On the other hand, although efficiency-seeking FDI in manufacturing and services involves only a part of the value chain, the market for which such production takes place is likely to be much larger than the host-country market, and that could make the employment generating capacity of such FDI greater than that of market-seeking FDI. Employment generation by natural-resource seeking FDI is likely to be less than that by either of the other two categories mentioned, because of the high capital intensity of the activities involved.

The quantitative effects of FDI on employment in a host economy depend on the employment generated directly within foreign affiliates and the direct and indirect effects of affiliate activity on employment in other enterprises (UNCTAD, 1999b: 261-269).

FDI increases host-country employment directly when it involves setting up new foreign affiliates or expanding existing affiliates. It can increase employment indirectly by stimulating additional employment in suppliers and distributors (depending on the intensity of local linkages). In the medium-term, employment can also increase through multiplier effects from the new income generated by FDI or through the higher demand stimulated by improved efficiency and restructuring of competing firms.

However, FDI that enters a host country through a merger or acquisition does not generally add to employment in the host country at the time of entry, and does not generate the indirect effects mentioned, although M&As may lead to sequential investments that generate employment later. FDI through acquisition can, however, preserve employment in a host country if it occurs through the acquisition and restructuring of firms that would otherwise go bankrupt.

FDI decreases employment in a host country directly when divestment and closure of foreign affiliates takes place. (Although, as FDI data show, divestment rarely exceeds new direct investment inflows for an economy as a whole, it does occur, particularly in special situations such as a prolonged economic crisis). It can also lead to a direct reduction in employment when mergers between parent companies in home countries lead to restructuring of foreign affiliates or when FDI enters a host economy through mergers or acquisitions that are accompanied by the restructuring of newly acquired firms in host countries involving lay-offs. FDI in privatized State-owned enterprises may, for instance be accompanied by job cutting, at least in the first instance (box 22). FDI can also have indirect effects reducing employment when domestic firms are crowded out due to FDI or when there is a restructuring of activities in formerly protected industries that FDI enters.

The overall effect of FDI on the quantity of employment in a host country depends on the balance between the positive and negative effects mentioned above. Estimates for the period from the mid-1980s to the late 1990s suggest that direct employment in foreign affiliates in developing countries is on the rise (for a summary see UNCTAD, 1999b: 265). It accounts for a very small percentage of total employment, on average, in developing countries, but in a number of countries, it is considerably larger in the manufacturing sector. For example, in the late 1990s, it accounted for 15 per cent or more of manufacturing employment in seven of the developing countries for which data were available (UNCTAD, 1999b: 408-409).

Box 22

The Buenos Aires water concession – effect on jobs

In Argentina, a recent review of five major privatization transactions (telecoms, electricity, gas, water and sanitation, and energy) found that close to 30 per cent of employees in the five enterprises lost their jobs by the time privatization took place. The reductions ranged from 3 per cent in telecoms to 72 per cent in energy. Drastic employment cuts were also made in other sectors, including railways and steel. Low productivity and interference by labor unions in management decisions had made the cost of keeping loss-making enterprises in the State sector so high that the government was willing to undertake the necessary employment reforms to facilitate privatization.

The signing of a concession contract for the Buenos Aires water and sanitation system in December 1992 attracted worldwide attention, and caused considerable controversy in Argentina. The major shareholder in the consortium that operates the water concession in Buenos Aires is Suez Lyonnaise des Eaux, a large French TNC. Since the concession came into operation the workforce was reduced from 7,600 employees to 4,000. The company argues, however, that 15,000 new jobs have been created around the concession on a sub-contracting basis and in other sectors, but this figure has been criticized by labour unions as an ambitious company estimate; moreover, it was argued that such jobs were non-unionized and did not comply with the health and safety standards fought for by the main water-sector union.

The government provided the concessionaire with $37 million to finance severance payments for 25 per cent of the workforce (about 1,800 workers), while an additional 1,700 workers were compensated by the new private company (for about $50 million). The new company completed the voluntary retirement programme within the first six months in accordance with the concession contract. Later, the concessionaire and the union negotiated a new collective bargaining agreement and a 40 per cent wage increase.

Sources: PPIAF Labor Toolkit (*http://www.ppiaf.org/ppiaf/page/toolkits*); Kikeri (1998).

5.2 Impact on quality of employment

The qualitative impacts of FDI on employment relates to wages, job security and conditions of work such as health and safety standards, hours of work, and workers' rights. FDI can affect key aspects of employment quality in the following ways (UNCTAD, 1999b: 269-273):

Wages. Foreign affiliates generally pay higher wages than domestic firms in similar activities. The difference is more marked in industries that demand higher levels of skill, technology and marketing and in export-oriented activities that need to ensure consistent quality and timely delivery, however, foreign affiliates in some labour-intensive export-oriented activities may pay low wages (that may not be particularly higher than wages in similar host-country firms) because their raison d'etre is tapping low-wage labour for simple assembly activities (UNCTAD, 1999b: 271).

Job security. Foreign affiliates tend to offer greater job security because of their size, competitive strength and need for a stable workforce. However, when FDI is motivated by low wages, employment in foreign affiliates is insecure, since they can move to other countries as wages rise. New employment practices (such as part-time work and short-term contracts with insufficient protection against layoffs) imported from home countries may also result in greater insecurity.

Other conditions of work. Working conditions in foreign affiliates are often better than those in local firms. In particular, large and visible TNCs tend to comply with local and international labour standards and even with labour standards in their home countries. This may not, however, be the case in low-end, labour-intensive industries; this is also related to the fact that some host governments may relax requirements on employment standards, and exempt some investors from the labour laws applicable in the host economy, as is the case in some EPZs (UNCTAD, 1999b: 273).

5.3 Enhancing skills

TNCs tend to upgrade skills of foreign-affiliate employees in host countries by investing in training (UNCTAD, 1999b: 274-276). Training may be on the job, or formal training within the firm or in specialized institutions. The purpose of such training is to earn a return for the TNC, and foreign affiliates may use various options (such as loyalty premiums in wages, promotions, or bonded training) to ensure that benefits stay mainly with them. Nevertheless, employees may leave foreign affiliates and carry their skills to other firms or set up their own firms.

Generally, TNCs also induce local suppliers and buyers to train workers to meet their quality standards and thereby indirectly influence local competitors or unrelated firms to emulate their training practices. They may also interact with local education and training institutions to improve training practices, curricula and links with industry.

Foreign affiliates of large developed-country firms accumulate extensive expertise in human resource management and enterprise-provided training and are generally better at providing training than local firms in developing countries. But TNCs investing to take advantage of low-cost labour may do relatively little training, though they may raise supervisory or technical skills to meet the standards of export markets. Skill upgrading may feed back into TNC activity and lead to further upgrading: TNCs can react to the availability of skills by raising the technological content of their investments, contributing to further learning and skill creation.

The role of FDI in skill building differs by sector, industry and even product line, and among host countries. For instance, in some situations, TNCs may start with training employees in low-skill categories and go on to invest in further training them as their wages rise and more complex technologies are used. In others, however, rising labour costs and technological upgrading may not converge. For example, in the case of export-oriented activities where FDI is aimed primarily at taking advantage of low-cost labour, TNCs may just move to other locations as wages rise.

5.4 Conclusion and policy implications

FDI can generate employment directly in host economies and can contribute to raising host-country employment through various indirect effects. It can also influence the quality of employment and workers' skills.

The quantitative effects of FDI on host-country employment depend mainly on the amount of net investment in new production activity, the nature of the activity (labour- or capital-intensive), the technology transferred, and the market orientation of foreign-affiliate production. In general, the potential for direct and indirect employment generation is larger in export-oriented FDI where the markets are often larger, although in large host economies, foreign affiliates producing for the local market may well have a larger employment impact and extractive industry FDI may be export-oriented but provide relatively little employment. The impact of FDI on host country employment also depends on the capabilities of domestic firms to sustain production and employment levels under conditions of increased competition, and on labour market mobility.

The effects of FDI on the quality of employment and the skills of workers in host economies depend on the activity and technology of the foreign affiliate, the nature of the labour markets in host economies and, in some cases, which TNC is investing. In general, the more efficient the labour markets and the higher the skill levels in a host economy, the greater the prospects of attracting (and benefiting from) FDI associated with high employment quality and good training practices.

Governments can influence the impact of FDI on the quantity of employment and on the upgrading of employment quality and skills through various policies. Such policies include those that work directly as well as those that work indirectly to influence FDI as well as the activities and behaviour of TNCs. The former focus explicitly on FDI and are implemented by investment promotion agencies or other similar agencies directly concerned with FDI. The latter work by enhancing the labour market environment and institutions, industrial relations, enterprise development and human resource development. They include, for example, measures available under trade, industrial, competition, and infrastructure policies as well as long-term policies related to science and technology and human resource development.

Measures to increase the quantity of employment generated within foreign affiliates include options such as measures to increase general investment; targeting employment-intensive FDI to the host economy as a whole or to particular regions; fiscal incentives such as tax deductions linked to jobs created; and provision of industrial parks or EPZs designed to attract low-cost labour-intensive FDI.

Measures to improve the quality of employment generated in foreign affiliates and raise skill capacity in foreign affiliates include strengthening basic education; launching schemes, to the extent feasible, in the public education system to provide training for the kind of activities governments wish to promote; promoting public-private partnerships for training, such as subsidizing training costs in private enterprises including foreign affiliates; fostering employee training programmes by companies, including foreign affiliates through tax deductions on training expenditure; skill audits by governments and channeling of information obtained to appropriate training institutions

In addition to measures related to human resource development for workers at the shop floor level, policy instruments to improve the availability and capabilities of professional personnel can help attract FDI that can upgrade employment quality and encourage it to do so. Payroll taxes can be calibrated financially to benefit a large-share of high-skilled employment. From a long-term perspective, tertiary education in areas such as engineering and management can be provided publicly or privately, while encouraging employment of local managers and other professionals through negotiations and/or fiscal incentives.

Good industrial relations can serve to enhance employment and advance the goal of upgrading employment quality and skills in foreign affiliates. They facilitate communications and accommodate constructive negotiations that can bridge the conflicting objectives of governments, TNCs and their affiliates, and representatives of labour. The type of institutions, laws, and standards in place with respect to trade unions and their collective bargaining rights, and labour-management relations vary greatly among countries. Regardless of how labour and management interact with each other, reliable relations and collective bargaining frameworks are essential for TNCs and their host-country affiliates to function effectively and for host country employment goals to be met.

At the international level, the principal instruments dealing specifically with TNCs and industrial relations are the OECD Guidelines for Multinational Enterprises (adopted in 1972), and the International Labour Organization (ILO) Declaration of Principles Concerning Multinational Enterprises and Social Policy (adopted in 1977) (UNCTAD, 1999b: 284). In addition, a series of core labour standards are enshrined in ILO conventions and apply to both domestic and foreign firms in a country. Labour unions, with the objective of enlarging opportunities for workers to organize and advance their interests, have focused on these core standards and sought commitments from companies and industry associations on the independent verification of systems for monitoring the observance of these codes. In the meanwhile, numerous corporate codes, some formulated in cooperation with non-governmental organizations (NGOs), have also emerged.

6 Effects in other areas: environment and competition

6.1 Protecting the environment

Protecting the environment is increasingly viewed as an integral part of sustainable development. Economic growth may, in the absence of appropriate action, degrade the environment, which may not be a sustainable process. At the same time, development offers new opportunities for environmental protection by increasing and diffusing more environmentally clean technologies and management systems and allowing for more environmentally friendly consumption patterns. The challenge for developing countries is to take advantage of these new opportunities and patterns in their development process.

TNCs, like other enterprises, should manage the environmental resources that are an input into their production processes through pollution-abatement practices, environmental management systems, education and training. Unlike other enterprises, they must also manage these issues across borders, in relation to their foreign affiliates.

Environmental management strategies of TNCs, like those of other enterprises, may be "end-of–the-pipe", where the focus is on "add-on" technology to address disposal and clean-up; or they may be process-oriented, where environmental damage is prevented from the outset. The choice may reflect different business perceptions of environmental strategies as well as the options available by virtue of different products and processes involved.

When it comes to cross-border environmental management within TNC systems, corporate strategies may be decentralized or centralized. Under the former, all environmental issues facing foreign affiliates are addressed at the host-country level, in compliance with local regulations. This could lead to variations in foreign affiliate behavior, depending on the stringency of host-country legislation. Under centralized strategies, environmental performance of a firm would be similar in all countries. The choice of strategy depends upon a mix of factors, such as the potential for environmental impact of the activities of a TNC; the implications for competitiveness of the affiliates and the TNC system as a whole; the threat of liability; uncertainty with respect to host-country policy; the role of consumer markets; home-country regulation; and the nature of the costs involved.

The environmental profile of FDI, i.e. the type of industry in which FDI takes place and, especially, the extent to which it involves pollution-intensive activities (UNCTAD, 1999b: 294), combined with the practices of TNCs with respect to efficient environmental management and transfer of technology by TNCs, are important determinants of their impact on host developing countries. TNCs are active in many industries with potentially high environmental impact. Inward FDI stock data suggest that the share of pollution intensive industries (industries such as chemicals, pulp and paper, petroleum and coal processing, basic metals industries and rubber and plastic products) in FDI stock of host countries is higher than that in domestic investment, in both developed and developing countries (UNCTAD, 1999b: 296-297). However, there is no conclusive evidence that TNCs generally invest in "pollution havens" or exploit environmental laxity.

TNCs – especially those from developed countries – have considerable experience with managing the environmental problems caused by process and product technologies. Many have also developed environmentally friendly processes, products and packaging to conform to standards and consumer preferences in their home countries, however the evidence with regard to the actual impact on the ability of host countries to protect their environment is mixed. It is also not clear that ownership matters in environmental impact. There is some evidence – although neither comprehensive nor systematic – to suggest that foreign affiliates may have higher standards than domestic counterparts across the entire manufacturing sector (UNCTAD, 1999b: 302), although, case studies also show that foreign ownership was not a significant factor in the adoption of ISO 14000 (certification that environmental management systems are in place) or in the adoption of plant-level abatement practices.

Despite the absence of systematic evidence allowing for a general conclusion about the importance of ownership when it comes to impact, it is important to note that one advantage held by TNCs in the area of environmental management is their basic ability to respond and adapt to change. This could be an important asset that foreign firms can bring to host developing countries. Host country policy measures could be designed to encourage TNCs to deploy this asset and to utilize more fully the potential they have to contribute to environmentally sound development. The challenge for policy makers is to balance their objective of accentuating positive environmental contributions of FDI and minimizing negative ones with their national goals in terms of increasing investment, exports, technology transfer and job creation.

Policy intervention can be made at the time of entry of FDI by requiring environmental screening before implementation of a project, regardless of nationality. This however, demands special skills. In any event, governments can require, especially in the case of big projects that TNCs provide their environmental policy statements and report regularly on their environmental performance. Furthermore, in large natural resource projects, environmental impact assessment studies are already standard procedure. In addition, FDI insurance agencies of home countries sometimes require environmental studies before they extend insurance and the Multilateral Investment Guarantee Agency requires that an environmental impact assessment be undertaken before it issues a guarantee for FDI from a member country (UNCTAD, 1999b: 307).

Once a foreign affiliate has been established, a host country's regulatory framework for environmental issues comes into play to influence its environmental performance. To enhance environmental performance and encourage TNCs (and domestic firms) to reduce their negative environmental impact, governments can consider a number of options such as passing environmental laws and regulations. These may include, for example, subsidizing the costs, or increasing tax deductions, for R&D expenditure related to clean technology; environmental management training and information technology support; reducing visa restrictions for persons associated with clean technology and environmental management training programmes; providing duty drawbacks or concessions for capital goods related to environmentally sound technology; requiring firms to employ the cleanest technology they have; monitoring the environmental impact of production and requiring annual environmental performance reporting; and encouraging foreign affiliates to work with their suppliers and customers to comply with environmental management systems.

At the international level, environment issues have been embedded in international agreements, with a view to enhancing the environmental contributions of FDI (UNCTAD, 1999b: 310). The Bolivia-US BIT, for example, makes reference to the environment. A North American Commission for Environmental Cooperation has been established within the framework of the NAFTA. Attempts have also been made to introduce provisions dealing with TNCs into intergovernmental policy documents and multilateral environmental agreements. For example, Agenda 21 provides a framework for environmental responsibility that makes explicit reference to the role of TNCs. The Montreal protocol on substances that deplete the ozone layer and the agreement establishing the Global Environmental Fund created a fund that provides resources to cover the incremental environmental costs of specific projects in developing countries.

6.2 Market structure and competition

Competitive markets are essential for the efficient functioning of an economy and hence, for the process of development. Competition thrives in markets with large numbers of buyers and sellers but, regardless of the number of participants, the basic condition required is that markets are open and contestable. FDI can influence market structure and competition in host economies, with implications for the performance of the industries and markets it enters.

The entry of FDI may initially add to the number of firms in a host country industry or market. TNCs flourish in concentrated markets: their main ownership advantages (in technology, product differentiation and organization) are found in oligopolistic industries with large firms. Thus their entry also tends to occur in concentrated industries and initially makes them less concentrated. However, TNC entry may force the exit of less efficient firms and thereby raise concentration levels again. As long as markets are contestable, the result could be a more efficient and competitive industrial structure. Much depends on the openness of a market to trade, intensity of local competition and the actual conduct of leading firms. The chances of abuse of market power are much greater in protected markets or in those in which the government favours selected enterprises. Patchy evidence available suggests that FDI may be associated with reduced concentration in developed countries and with increased concentration in developing ones, where strong domestic firms are relatively scarce. As to effects on competition, the evidence from developing countries is mixed (UNCTAD, 2000: 193).

TNC entry puts competitive pressure on domestic firms in host countries (UNCTAD, 1999b: 66). There is evidence that this leads to an increase in product quality, variety and innovation in host economies, but little evidence that it lowers prices (UNCTAD, 2000: 193). Domestic firms may react to the competitive pressure by enhancing capabilities or be forced out altogether. Both might be desirable outcomes as long as they reflect genuine market forces rather than predatory behavior by foreign facilities. However, when domestic firms of low-quality, low-price goods and services go bankrupt and these products disappear, the low-income population is deprived of inexpensive and therefore preferable suppliers. Predatory conduct by foreign affiliates also remains a significant risk, although recent investment and trade liberalization have raised contestability in national markets. The urgency of effective competition policy remains strong for host economies.

Another important issue related to the effects of FDI on competition in host developing countries is the question of the impact on competition of foreign purchases of State-owned companies that hold monopoly positions. The problem is particularly acute in the case of natural monopolies, where (often complex) regulatory structures and rules need to be in place to avoid simple profit-maximizing behavior. Developed countries (and some developing countries) are experimenting with different policies, like introducing competition in particular segments where several producers can operate (e.g. power generation) or regulating and assessing the operation of monopolies in various ways (yardstick competition, price setting or negotiated rates of return). The impact of FDI is, in this context, part of the larger array of regulatory issues.

7 Conclusion

Most developing countries currently encourage FDI in their economies with an aim to supplement and complement domestic resources and efforts for development with those that FDI brings. However, the economic effects of FDI are complex and depend on a number of factors related to TNC motivations and strategies as well as host-country conditions both economic and policy-related. FDI represents a package of attributes that vary among locations and industries in which TNCs operate, with the potential for benefits as well as risks from the point of view of a host developing country.

FDI brings capital resources to the host country and can add to productive investment that can contribute to development. It may also bring technology, access to new markets, managerial, organizational and marketing know-how, and skills; it can stimulate the competitiveness of domestic enterprises and contribute directly and indirectly to employment generation. By helping host countries build competitive advantages and improve their performance in various areas, FDI can improve their ability to participate effectively in the global economy while pursuing their development objectives (annex, table 8). However, FDI can also affect various aspects of host economies adversely. Taken together, the potential contributions that FDI offers mean that FDI can contribute positively to economic development in host countries, provided host-country economic conditions, policy environment and policy initiatives related to FDI are such that they induce TNCs to invest and transfer the advantages sought, and provided countries can counter the potential risks and use those advantages in line with their development objectives. In other words, benefits are often not automatic, and carefully designed government policies are generally needed to promote them and reduce negative impacts in line with the priorities of a host country.

Exercises and questions for discussion

1. What is the general objective pursued by TNCs?
2. What is the main objective of host countries when they seek to attract FDI?
3. Why and how can TNCs contribute to a host country's development objectives?
4. How can host countries influence TNC activities?
5. What potential advantages can FDI inflows bring to host economies, compared to other types of foreign capital inflows? What possible risks can it bring?
6. Describe the global evolution of FDI flows relative to other external resource flows to developing countries, as well as to domestic investment of those countries. What is the situation in your country in this respect?
7. What are the possible effects of FDI on the balance of payments that might raise concerns of a host developing country?
8. Define transfer pricing and explain its possible impact on a host developing economy.
9. Explain the difference between crowding in and crowding out domestic investors. Discuss in groups the main positive and negative effects that FDI can have on the activity of domestic competitors.
10. Give an example of an internalized technology transfer, and an example of an externalized transfer.
11. Using the examples in box 16, discuss the role host countries can play in maximizing TNCs' contribution to building domestic technological capabilities.
12. Discuss in two groups the advantages (group 1) and disadvantages (group 2) of internalized technology transfers versus externalized transfers, from the point of view of the host country.
    Discuss in two groups the advantages (group 3) and disadvantages (group 4) of internalized technology transfers versus externalized transfers, from the point of view of a TNC.
    At the end, discuss (group 1 with group 4, group 2 with group 3) and share your conclusions with each other.
13. Give reasons why the trend towards R&D internationalization is likely to continue. Why do some developing countries attract FDI in R&D activities, while many others do not?
14. Name three possible ways in which foreign affiliates can access foreign markets more easily than domestic firms.
15. Find and discuss in groups examples of products made by a TNC in your country or region that are exported to other countries of the region.
16. In your opinion, what factors can prevent opportunistic behaviour of foreign investors with regard to the environment? Discuss cases from your country or region.

Exercises and questions for discussion

17. Identify and discuss in groups the positive and negative effects of FDI on a host country's employment.

18. In your opinion, what factors can prevent opportunistic behaviour of foreign investors with regards to the environment? Discuss cases from your country or region.

19. Practical exercises

Case study 1: Thailand in Toyota's global R&D network (UNCTAD, 2005: 145)

Toyota Motor Corporation founded the "Toyota Technical Center Asia Pacific (Thailand)" in Thailand in August 2003. The centre was officially opened in May 2005. Toyota has invested 1.1 billion baht ($27 million) into this centre so far. During the two-year preparation for opening, almost all locally recruited engineers and scientists were sent to Japan for a training period of 6 to 12 months. When it first opened, the company employed 275 persons (including 32 Japanese), of which 250 were engineers and technicians (2 per cent of Toyota's global R&D staff). The centre has both a regional mandate for Asia (excluding China) and a global one to carry out R&D for the parent corporation. The center is in charge of projects in basic research, technology development, research on market conditions and design, along with testing and evaluation. Thailand was chosen as a location for Toyota's Asian R&D center for various reasons. The existence of a manufacturing and sales affiliate there was an important consideration, although there is no equity or administrative link between the two units. Other reasons include good local infrastructure, political stability, favourable geographical location, a skilled labour force and favourable government policies (including incentives). In the area of policies, outstanding issues include the eventual exemption from customs duties of materials (such as motor vehicles) imported for testing, and the provision of full licenses for test-driving.

Questions:

- How did the transfer of technology take place in this case? What did it involve?
- What factors influenced Toyota's decision to establish its technical centre in Thailand?
- What are the likely benefits for the host country?

Case study 2: FDI and upgrading competitiveness in the Indian software industry (UNCTAD, 1999b)

The Indian software export industry, based around Bangalore, Mumbai, Delhi and Madras, had a significant boost in the initial stages from foreign investors. In 1985, Citibank established a wholly-owned, export-oriented, offshore software company in the Santa Cruz Electronics Export Processing Zone in Mumbai. India's attractions were twofold: low-cost English-speaking skilled labour and a time difference between Europe and North America that allowed for almost 24-hour workdays. The bulk of FDI in this industry went into what is known in the software industry as low-level data entry work. This refers to contracts in which the client gives software developers exact specifications, and leaves little to the discretion or creativity of the programmers. This form of export activity did not, however, promise much by way of skill upgrading. An integral part of the restructuring of the industry was the attraction of Texas Instruments (TI), which established its first wholly owned export-oriented subsidiary. In addition to regulatory accommodation, the Government of India developed the Software Technology Parks of India Scheme, where it provided infrastructure, buildings, electricity, telecommunications facilities and high-speed satellite links. Not much after, Hewlett-Packard (HP) set up a 100 per cent owned subsidiary in Bangalore. In 1990-1991, quantitative restrictions on imports of intermediate and capital goods for software exports were abolished. The TI and HP investments intervened in the Indian software industry at a critical stage of its development. Since then, many domestic firms have developed a reputation for reliable, high quality work at relatively low cost, and have been able to move beyond simple data entry or on-site services. They have won higher value-added work where they are entrusted with a whole project instead of specific components. Others have been able to develop complete software packages, which are rebadged and sold overseas (similar to the OEM relationship in consumer electronics). The export competitiveness of the Indian software industry is now well established. Exports rose rapidly after 1995. The five largest software companies in India today are domestically owned. TNCs played an important initial role in mobilizing domestic capabilities. With government assistance and the removal of import restrictions, domestic companies were then able to supersede foreign affiliates in terms of export competitiveness.

Questions:

- What were the main factors that attracted FDI in the software industry to India?
- What was the role of the Government in encouraging FDI in the software industry and helping domestic firms in the industry build up their export competitiveness?

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MODULE 2

Policy aspects of FDI in developing countries

INTRODUCTION TO MODULE 2

As countries seek to attract FDI that could most benefit their economies and their development, national and international policies can help limit FDI's potential costs and risks while enhancing its contributions to host economies. Over the past few decades, developing countries have devoted considerable attention to improving their national policy frameworks for FDI, as well as to entering into international agreements at the bilateral, regional and interregional levels.

In formulating and implementing national FDI policies, developing countries work to attract FDI in order to benefit to the maximum possible extent, while still addressing concerns surrounding it. In the past few decades, most countries' efforts at the national level have focused on creating a stable, friendly and predictable investment climate, through liberalization, promotion and protection of foreign investment. But many are doing so carefully, using instruments that are expected to better address their development objectives. Furthermore, as competition for FDI has increased, investment promotion practices and tools used by host countries have become more sophisticated. The current approach in investment promotion seeks to match foreign companies' strategies with the host country's location advantages as well as with its development needs through targeted investment promotion.

At the international level, the considerable increase of investment and investment-related agreements at the bilateral, regional, interregional, and plurilateral levels, which proliferated in the absence of consensus on a multilateral agreement, has led to a complex international investment framework, which is not always comprehensive and is very challenging for host countries, especially developing ones. Bilateral investment treaties, double taxation treaties (DTTs) and many other types of bilateral, regional and interregional agreements with investment provisions have all brought the number of international investment rules to a record level. This has been paralleled by a rise in the number of international investment disputes. International investment rule making is likely to intensify further in the years to come as a large number of IIAs are currently under negotiation or re-negotiation, and investment is increasingly integrated in agreements that encompass a broader range of issues, such as trade in goods and services, and other factors of production.

Multiplying international investment rules have implications for host countries' policy space. Some key issues in national policies, primarily those related to entry, operations and protection of FDI can interact in a complex manner with the international commitments of a country. The flexibility for governments to successfully pursue their development objectives requires the international commitments of the country to be coherent and consistent with its national policies. This creates a challenge not only for the negotiation and design of IIAs, but also their implementation.

This module begins by considering the key aspects of FDI policy at the national level (theme 1). It then discusses the main features of the international investment framework including the evolution of and recent trends in IIAs, and the key issues for consideration regarding the relationship between national and international policies with respect to FDI (theme 2).

THEME 1
Key national FDI policies in host developing countries

INTRODUCTION

Developing countries are increasingly trying to attract FDI and to benefit from it to the maximum extent possible. Many have moved or are moving towards market-friendly policies and liberal regimes for FDI in their economies, similar to those that developed countries have implemented for some time. But many are doing so carefully, since their market structures are weaker and their development needs and concerns more pressing. Accordingly, they focus more on elaborating and using policy instruments or measures that can better address their development objectives both with regard to attracting investment and with regard to achieving objectives with respect to various areas of FDI impact.

As noted in the discussion of policies as determinants of FDI in host countries (Module 1, theme 3), the national policy framework for FDI includes core policies or policies directly related to FDI as well as other policies that indirectly affect FDI. The discussion in this handbook focuses on policies directly related to FDI – that is, policies regarding the entry, treatment, protection and promotion of FDI and competition – as well as the measures or instruments by which these items are implemented. It also considers the way and means by which good governance in investment promotion can be fostered to complement measures to promote FDI.

Host countries' efforts to create national FDI regimes that are investor friendly and also address development priorities and concerns take place alongside efforts and policies at the international level. In that context, issues that national policy makers face in policy-making need to also be considered in light of the interaction between national and international policies and policy instruments. Some key issues relate to the treatment of FDI at entry and subsequent operations of foreign affiliates; nationalization and expropriation, including indirect takings of foreign-owned property, and related compensation; mechanisms for dispute settlement; the use of performance requirements and incentives; encouragement of transfer of technology; and ensuring competition, including the control of restrictive business practices by foreign affiliates. (These and other issues are also analyzed from the point of view of IIAs in Module 3 of this manual).

Investment promotion efforts are made mainly at the national level and include: communication of information by the host country, the opportunities it offers to investors and the process of convincing those investors to invest.

In the context of increasing competition for FDI, countries use sophisticated promotion techniques and offer a wide range of services to investors to target and retain particularly valuable investments. However, successful investment promotion also depends on the more general requirements of good governance in the host country, such as accountability, predictability, transparency and participation.

At the end of this theme, students should be able to:

- Understand the main objectives of national FDI policies and measures;
- Be able to relate FDI policies and measures to the main objectives;
- Understand and analyze the evolution of FDI policies, especially those of developing countries;
- Understand and analyze key issues in formulating national FDI policies in the context of international investment agreements;
- Understand FDI promotion measures in the context of competition for FDI; and
- Understand the role of good governance in investment promotion and analyze its main components.

HANDBOOK

1 National FDI policies: main objectives and measures

The main objectives of host countries' policies on FDI include attracting FDI, ensuring that the host economy derives full economic benefits from FDI, and addressing concerns about the potential negative effects of FDI on the host economy. Developing countries use a range of policies and measures at the national level to pursue these objectives in the context of their development efforts.

As noted in the discussion of FDI determinants (Module 1, theme 3), FDI policies include policies directly related to FDI, which are known as "core" FDI policies, as well as policies that indirectly influence FDI, or "outer circle" policies. The discussion in this and subsequent sections of this handbook focuses on core FDI policies and related measures, although, as emphasized in the discussion of FDI determinants, non-core policies such as those related to trade and taxation can exert a strong influence on FDI inflows. Core FDI policies and measures are identified as policies, rules and regulations regarding the entry and operations of foreign investors, the standards of treatment accorded to them (in terms of discrimination or lack thereof as well as protection) and the functioning of the markets within which they operate (UNCTAD, 1998: 92). Investment promotion and related measures, which also directly affect FDI flows and activities but are facilitating rather than enabling in nature, may also be considered as belonging to the core group.

In pursuing the objectives of attracting, benefiting from and addressing concerns with respect to FDI and its impacts, countries use measures related to one or more of the core FDI policies mentioned above. Measures used to achieve one objective may overlap or conflict with those required for achieving another. The scope and variety of measures that may be used with respect to the three above-mentioned objectives and others (such as those pertaining to investment in general, including domestic investment as well as FDI) are illustrated by the measures listed in the annex. Specific measures relevant for enhancing the development impact of FDI in various key areas have also been mentioned in the handbook on FDI and development (Module 1, theme 4).

1.1 Attracting FDI

Countries can attract FDI in many ways. They can adopt liberal policies with respect to the admission of foreign investors and the establishment of foreign affiliates. They can, in addition, adopt measures to protect foreign investors' assets and facilitate transfers of funds by investors. They can also encourage FDI inflows, either in general, without trying to attract particular kinds of investment or selectively, focusing on certain investors, regions or industries.

Policy measures are often implemented in a combined way, for example by combining openness to foreign investors with the creation of a better investment climate and putting special effort into bringing in a particularly desirable investment.

The main ways in which countries have sought to attract increased quantities of FDI are (UNCTAD, 2003a: 87):

- **Reducing obstacles to FDI** by removing restrictions on admission and establishment, as well as on the operations of foreign affiliates. The key issues here are how investment is to be defined for liberalizing entry or offering protection and what kind of control should be exercised over FDI admission and establishment.

- **Improving standards of treatment of foreign investors** by granting them non-discriminatory, and sometimes better, treatment *vis-à-vis* domestic or other foreign investors. The key issue here is what degree of national treatment should be granted to foreign affiliates once they are established in a host country.

- **Protecting foreign investors** through provisions on compensation in the event of nationalization or expropriation, on dispute settlement and on guarantees for the transfer of funds. A key issue here is how far the right to expropriate or nationalize extends (especially to what extent certain regulatory actions of governments constitute takings of foreign property).

- **Promoting FDI inflows** through measures that improve the host country's image, provide information on investment opportunities, provide incentives, facilitate FDI through specific institutional and administrative mechanisms or provide post-investment services. Host countries do most of this, but home countries may also play a role. The key issues here relate to the use of financial, fiscal or other incentives (including regulatory concessions) and the actions that home countries can take to encourage FDI flows to developing countries.

The general trend with respect to policies to attract FDI has been to reduce obstacles, create investor-friendly settings and promote FDI. But the measures applied by countries vary due to a variety of reasons including differences in location advantage, increased cost of some measures over others, and differences in government's perceptions of how best to attract FDI.

1.2 Benefiting from FDI

Attracting FDI may not be enough to ensure that a host economy will benefit to the full extent possible from it. Foreign investors respond to investment opportunities according to their strategies with the objective of profit, and the outcome may not necessarily benefit a host-country's development to the extent or in the manner sought. But policies can induce investors to act in ways that enhance the development impact – by the transfer of technology, enhancing local skills, the use of local suppliers and so on.

The main policies and measures used by countries to maximize the positive contribution of FDI in development are (UNCTAD, 2003a: 87):

- **Mandatory measures**. These measures prescribe what foreign affiliates must do with respect to certain aspects of their performance that are related to the development objectives of the host country, such as, to increase exports, to hire and train local workers or to transfer technology. Such measures, or performance requirements, may require foreign affiliates, for instance, to export a given level or percentage of goods or services produced, to purchase or accord a preference to goods produced in the territory of the host country, or to transfer a particular production process. However, the use of mandatory performance requirements is declining for a number of reasons (UNCTAD, 2003a: 119-120), including the prohibition under WTO rules of certain performance requirements considered to be trade distorting; the risk of deterring FDI or affecting competitive performance by limiting the freedom of foreign investors to decide about certain elements of their activity and distorting the allocation of resources; and a growing preference for market-friendly tools to meet development objectives.

- **Encouraging foreign affiliates to act in a desired way, including offering incentives**. In addition to encouragement in the form of specific information-provision or cooperation between host governments and foreign affiliates, incentives are a major form of encouragement. Incentives are measures (such as tax deductions, the provision of infrastructure, subsidies on inputs or preferential loans) designed either to increase the rate of return of an FDI undertaking or to reduce its costs or risks. They may be used to influence the behaviour of foreign affiliates, for example, with respect to the employment generated or training provided. In some cases, incentives may be tied to performance requirements. However, incentives do not impact automatically on investment decisions, and in some cases their cost for the host country may exceed the benefits of the targeted or attracted FDI (see also Module 1, theme 3).

When considering policies and measures directed towards maximizing the benefits of FDI for their economies, host countries are have increasingly realized that they can influence foreign affiliates to behave in ways that enhance FDI benefits only if they strengthen their national capabilities – new technologies can be disseminated in a host economy only if the skill base is adequate enough or if domestic suppliers and competitors can meet TNC needs and learn from them; export activity can grow only if the quality of infrastructure so permits. Accordingly, governments are also focusing on elaborating and implementing policies to build domestic capabilities, drawing on foreign affiliates and their parent firms in this effort. Again, home countries can help in various ways through measures of their own. Indeed, even TNCs can try to increase the benefits to host economies.

1.3 Addressing concerns about the impact of FDI

Despite a general shift in attitudes in favour of FDI over the past decade, significant concerns remain regarding its potential negative effects. Some major areas of concern are (UNCTAD, 2003a: 88):

- Anticompetitive practices by foreign affiliates;
- Volatile flows of investment and related payments with a negative impact on the balance of payments;
- Tax avoidance and abusive transfer pricing by foreign affiliates;
- Transfers of polluting activities or technologies;
- Crowding out local firms and discouraging domestic entrepreneurial development;
- Crowding out local products, technologies, networks and business practices with harmful socio-cultural effects;

- Concessions to TNCs, especially in export processing zones, regarding skilled labour and environmental regulations;
- Influence on decision-making in economic affairs of the host country, with possible negative effects on industrial development and national security.

Such concerns were shared in the past by both developing and developed countries. These concerns underlie many of the controls and conditions that countries have imposed on FDI entry and operation. Despite significant changes in attitudes towards FDI, they remain strong for many countries, in particular for developing countries facing difficult economic conditions. The main policies and measures used to address concerns regarding adverse impacts include:

- Restrictions relating to the admission of FDI and on the establishment and operations of foreign affiliates. For example, entry through M&As may not be allowed due to concerns related to domestic enterprise development, investors may not be allowed in certain zones or regions of a country due to regional planning or national security considerations, or environmental impact assessments may be a precondition for FDI entry into certain industries in a host country.

- Measures relating to the operations of foreign affiliates. Certain requirements may be placed on the operations of foreign affiliates due to concerns related to potential impacts. For example, export earning requirements or restrictions on capital imports may be imposed to mitigate possible negative impact on the balance-of-payments problems, foreign affiliates may be excluded as suppliers to government procurement programmes, or their access to local credit facilities may be restricted due to concerns regarding crowding out of domestic enterprises.

Many governments concerned about risks of possible adverse effects feel the need to exercise caution with regard to the entry and operation of TNCs and to control or influence the operations of foreign affiliates. Such considerations may also influence their rules and regulations with respect to transfers of funds by foreign investors and settlement of disputes involving foreign investors.

2 Evolution of FDI policies

During the post World War II period until the early 1980s, many countries were skeptical about the role of FDI in the functioning and development of their economies, and limited or excluded FDI inflows. Their attitudes and policies towards FDI were partly the consequence of political orientation that favoured State control over the economy, as in socialist countries, or partly due to the decolonization process that took place in many developing countries. However, they were also the result of development strategies that emphasized building domestic enterprises and capacity, often within a protected environment.

The 1990s witnessed an unprecedented and sustained trend towards liberalization of developing countries' economic policies with respect to FDI. In most cases, that trend accompanied the liberalization of economic policies generally. For some developing countries, the trend towards liberalization of FDI policies began in the early 1980s, when the debt-crisis that affected many of those countries led to them perceiving FDI in a more favourable light than in the past. By the early 1990s, the trend towards FDI liberalization gathered significant momentum. An increasing number of countries revised their views regarding the role of FDI due to various factors, including lessons learned from experience and growing competitive pressures in a globalizing world.

Today, the situation is radically different from that of two decades ago. Indeed, most developing countries not only allow FDI but seek to attract it with a view to incorporate it more fully into their development strategies. Globalization has pushed economic activities significantly beyond State frontiers and at the same time, competition for FDI between countries has increased. Countries with pressing development needs consider FDI a major resource for their economic development and virtually all developing countries have sought to establish an enabling policy and regulatory framework with a view to encourage FDI to the maximum extent possible. At the same time, developed countries have also engaged in the liberalization of policies in some areas, such as services, that remained relatively closed to FDI. As a result, nearly every country currently not only allows FDI but tries to attract it as well.

Data on changes in national laws and regulations gathered by UNCTAD highlight the strong trend towards liberalization of FDI policies. Between 1992 and 2008, a total of 2,650 changes were made in national regulations by countries included in the research, and the vast majority of these changes were more favourable to FDI (table 2). UNCTAD's 2008 survey of Changes to National Laws and Regulations related to FDI indicates that 110 new FDI-related measures were introduced by a total of 55 countries. Of these, 85 measures were more favourable to FDI. When the percentage of less favourable measures is compared to the previous year, measures for FDI remained unchanged at 23 per cent.

Changes towards more friendly investment regimes usually involved a higher degree of liberalization of FDI regimes, more protection offered to investors and more promotional efforts. Thus, they focused on removing entry restrictions, higher standards of treatment, more guarantees in case of expropriation, less restrictions to the transfer of funds, more flexibility regarding the dispute settlement mechanism, more complex and targeted investment promotion, more services offered to investors and/or more incentives.

Table 2

Changes in national regulations related to FDI, 1992-2008

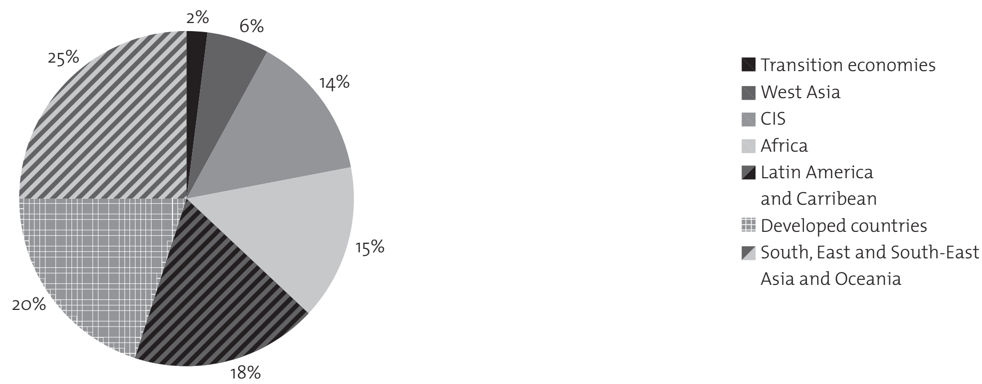
	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07	08
Number of countries that introduced changes	43	56	49	63	66	76	60	65	70	71	72	82	103	92	91	58	55
Number of regulatory changes	77	100	110	112	114	150	145	139	150	207	246	242	270	203	177	98	110
More favourable	77	99	108	106	98	134	136	130	147	193	234	218	234	162	142	74	85
Less favourable	0	1	2	6	16	16	9	9	3	14	12	24	36	41	35	24	25

Source: UNCTAD (2009: 31).

Changes in FDI regimes involve FDI-specific laws as well as others. However, over time, many host countries have adopted FDI-specific laws in one form or another, spelling out the main features of their FDI regimes. From a regional perspective, South, East and South-East Asia and Oceania had the highest share of regulatory changes – 25 per cent, followed by developed countries – 20 per cent. In all regions, the number of changes more favourable to FDI clearly exceeded those that were less favourable. They accounted for 75 per cent of the 16 measures adopted in Africa, 79 per cent of the 28 measures adopted in South, East and South-East Asia and Oceania, 80 per cent of the 15 measures adopted in the CIS, 91 per cent of the 22 measures in the developed countries, 55 per cent of the 20 measures adopted in Latin America, and 89 per cent of the 9 measures taken in West Asia and the SEE countries combined. Out of the 110 new measures adopted during the review period, 33 per cent introduced more favourable entry regulations, and another 44 per centof all measures improved the treatment or operations. Only 13 per cent and 10 per centwere less favourable in entry and treatment or operations, respectively (figure 21).

Figure 20

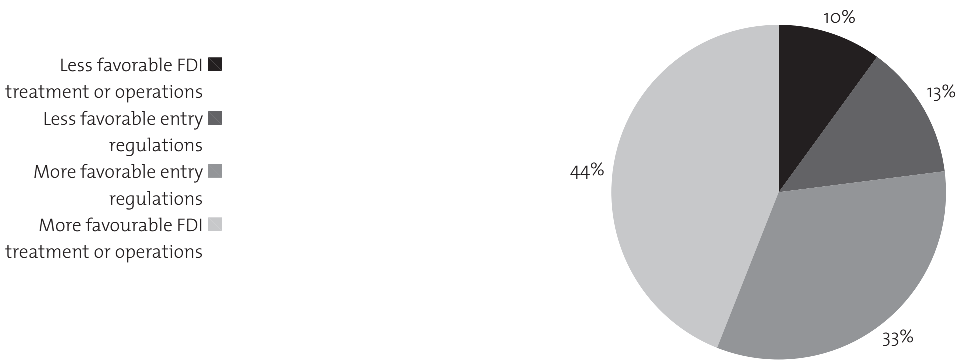
Regional distribution of FDI related measures in 2008



Source: UNCTAD (2009: 30).

Figure 21

Nature of FDI related measures in 2008



Source: UNCTAD (2009: 30).

3 Key issues in national FDI policies

In formulating and implementing national FDI policies, governments face a number of issues related to balancing different objectives with respect to FDI and balancing FDI policies with policies related to other aspects of their economies. Furthermore, as countries increasingly enter into international investment agreements, they have to reconcile various aspects of their national policies and regulatory frameworks with the international commitments they undertake. In this context, a number of issues assume particular significance in terms of the attention they deserve from policy makers when devising national FDI policies (as well as while negotiating IIAs). These include, in particular (UNCTAD, 2003a: 99):

- How to define investment;
- How to treat the entry of FDI and the subsequent operations of foreign affiliates (the most important question being that of "national treatment" before and after entry);
- What protection standards to use for takings of property including nationalization or expropriation of foreign investors' property as well indirect takings, and where to draw the line between regulatory takings and legitimate policy action;
- What mechanisms to use for dispute settlement;
- How to use performance requirements and incentives;
- How to encourage the transfer of technology;
- How to ensure competition, including the control of restrictive business practices by foreign affiliates.

These issues are important in their own right for national policy-making, but assume particular significance in the context of international rule making. They will also be discussed in Module 3 from a legal perspective and with special reference to IIAs. The discussion below briefly considers each of them from the point of view of national policies and the interaction between national policies and IIAs.

One issue that is important in the context of the interaction between national FDI policies and IIAs but which is not related to national FDI policies, per se, and is therefore not considered below, is the question of the definition of investment in national laws and international agreements. The main question regarding the definition of investment in national laws and IIAs is not whether FDI should be defined as investment – it is (UNCTAD, 2003a: 100). The question is, what other investment should be also granted the same status: portfolio investment (both equity and debt components), other capital flows (bank loans, nonbank loans and other capital flows), and various investment assets (both tangible and intangible) including intellectual property rights (IPRs).

3.1 National treatment

Treatment of FDI with respect to its entry and subsequent operations of foreign affiliates is probably the most important issue related to national FDI policy. In today's usage, the first aspect (treatment with respect to entry) raises the question of national treatment prior to establishment and the second aspect (treatment of foreign affiliates' operations), that of national treatment in the post-establishment phase. "National treatment" can be defined as "a principle whereby a host country extends to foreign investors treatment that is at least as favourable as the treatment that it accords to its national investors in like circumstances" (UNCTAD, 1999: 102).

The right to control admission and establishment has traditionally been the single most important instrument for the regulation of FDI. Not surprisingly, restrictions remain even now and no country offers an unconditional right of admission to foreign investors. Most non-OECD governments preserve their right to control FDI admission and establishment in the IIAs to which they are parties. Control measures that countries use can range from total to sectoral exclusion of FDI as well as a variety of restrictions e.g. on ownership share allowed foreign investors, joint venture requirements, or the screening of entry by a designated agency. Once foreign investments are established, host countries generally provide national treatment to foreign affiliates; but typically the condition of "like circumstances" prevails, leaving open the possibility for governments to provide special support to national firms in different circumstances.

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

(a) What is the economic case for the liberalization of FDI policies?
(b) What is the case for exercising control on FDI admission and establishment?
(c) What are the main considerations for national treatment once TNCs have been allowed to enter an economy?

The central issue with respect to pre-establishment national treatment for host countries relates to the promotion of national enterprises and building and enhancing domestic capabilities. Under free market conditions, unrestricted FDI entry may curtail local enterprise development and generate smaller spillovers than local firms. The main areas of concern are:

- **Protecting infant entrepreneurship**. FDI could harm the development of local entrepreneurship by deterring potential domestic investors from entering activities with a strong foreign presence – crowding them out where they exist. The infant enterprise argument is similar to the infant industry argument: building competitive capabilities by domestic firms takes time, and investment is risky and learning is costly.

- **Local technological stregthening**. A strong foreign presence could deter local competitors from investing in risky innovation (or other) capabilities, as opposed to buying ready-made technologies or skills from abroad; moreover, if FDI deters R&D in local firms, the technological gap between them and TNCs can grow, marginalizing them in technology-intensive activities.

- **Exploitation of new technology**. Where both local and foreign firms engage in R&D activity and create new technologies, local firms may exploit the benefits of innovation within the host economy more than foreign affiliates, which may transmit the knowledge to parent companies to exploit them elsewhere.

- **Greater spillovers**. Even where local and foreign firms are similar in other respects, local firms could create greater spillover benefits because they have better local knowledge and a stronger local commitment. They may procure more inputs locally, use more local skills and interact more intensely with local technology and training institutions and so on.

- **Footloose activity**. Foreign investors are likely to relocate to other countries more readily than domestic firms as conditions change. Domestic firms are likely to have a stronger commitment to the home economy – and as such are likely to invest more in improving the local competitive base.

- **Loss of economic control**. Foreign affiliates respond to signals from international markets and to the strategies of decision makers based overseas. They could also be responsive to pressures from home country governments. Where local and foreign interests or perceptions diverge or where sensitive technologies or activities are involved, this may impose a cost on the host economy.

For these and other reasons, host countries may not wish to grant freedom of entry or pre-establishment national treatment to foreign investors in certain sectors or industries, especially where the risk of crowding out domestic competitors is high. Or they may, for instance, encourage R&D activities of domestic firms through various incentives not available to foreign investors, thus establishing a difference in treatment. Moreover, many governments that want to attract FDI for advantages such as advanced technology or exports may feel that local enterprises need not face unnecessary competition from FDI if foreign investors do not offer such advantages. Some governments are particularly sensitive about opening activities populated by SMEs that generate considerable employment and that may embody strong community, craft, design or other traditions.

While the arguments listed above have merits, evidence from experience of restrictions on FDI entry is mixed (UNCTAD, 2003a: 106). It suggests that there may be good economic reasons for restricting FDI or liberalizing entry selectively and gradually. But the tool has to be used carefully.

When it comes to the question of treatment of foreign affiliates and whether post-establishment national treatment should be accorded, an economic case may be made on grounds of market and institutional failures (UNCTAD, 2003a: 107).

First, foreign affiliates tend to be more efficient and may therefore be denied national treatment on "infant enterprise" grounds, provided the differentiation in treatment is for a limited period and local enterprises are able to become fully competitive.[19]

[19] Denying foreign affiliates national treatment on infant enterprise grounds is justified only if the differentiation is limited in duration and local enterprises are able to become fully competitive.

Second, foreign affiliates may have advantages over local firms, not because they are more efficient but because markets for credit, skills and so on are segmented and give them better terms simply because of their foreign ownership. But offering better terms to local firms to offset the adverse effects of market segmentation is a second-best solution and, moreover, segmentation is difficult to distinguish from healthy commercial practice.

Third, foreign affiliates may need to be restricted from privileges that give them access to sensitive strategic information or technologies, or to activities of cultural and social significance. This non-economic argument is difficult to evaluate, but is important, and many otherwise FDI-friendly governments give certain privileges (e.g. regarding access to defence-related activities) to national firms.

Fourth, foreign affiliates may become dominant and abuse their market power. Preventing this by discriminatory treatment is a second-best solution. The best solution would be to strengthen competition policy.

As the above arguments indicate, there are several reasons why governments prefer to retain the freedom to impose controls on FDI entry and exercise flexibility according to national treatment in the post-establishment phase. On the other hand, national treatment at entry and post-establishment are central to the worldwide strategies of TNCs. Entry is the first (essential) step to transnational operations, and national treatment in the pre-establishment phase allows enterprises freedom of access to markets and resources and to acquire a portfolio of location assets strengthening their competitiveness. Post-entry national treatment then allows them to compete on an equal footing with domestic enterprises. Thus, in negotiating IIAs, some countries might want to grant national treatment to FDI in order to attract foreign investors, or to support outward investors from their countries.

The great majority of IIAs preserve full governmental control over admission and establishment while granting national treatment in the post-establishment phase of an investment (UNCTAD, 2003a: 107-108). Disputes are increasing, however, regarding national treatment. Main questions that arise relate to treatment standards. When are two situations really alike? When is treatment "less favourable" to the foreign investor? What is the policy justification for the alleged difference in treatment? Is there intention to discriminate on the part of a host country?

One way in which the conflicting interests of policy makers with different national priorities may be reconciled is through exceptions in IIAs. Both pre and post establishment national treatments are generally subject to exceptions. Exceptions based on economic development concerns are particularly important for developing countries. They help countries maintain flexibility in pursuing their development objectives through national FDI policies, while benefiting from participation in IIAs.

3.2 Nationalization, expropriation and other regulatory takings

"Takings of property" through nationalizations and expropriations are the oldest issue in FDI regulation (UNCTAD, 2003a: 110). Major takings of foreign-owned property in the 20th century have led to rules of customary international law that sought to establish the conditions under which such takings could be lawful. These laws established that it must be for a public purpose, be non-discriminatory and give rise to the payment of compensation. These basic principles have generally been accepted in national laws and practices and extensively referred to in IIAs.

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

Distinguishing between various categories of takings of property is not always easy.

- **Direct takings** of property involve the transfer of the physical possession of an asset as well as the legal title. They can take various forms, ranging from outright nationalizations in all economic sectors or on an industry-wide basis, to large-scale takings of land by the State, or specific takings (expropriations).

- **Indirect takings** do not involve the transfer of property rights. They include creeping expropriations, involving an incremental but cumulative encroachment on one or more of the ownership rights until the measures involved lead to the effective negation of the owner's interest in the property. They also include regulatory takings, in which the exercise of governmental regulatory power – the power to tax or to control operations for environmental protection – diminishes the economic value of the owners' property without depriving them of formal ownership.

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

Regulatory takings are a particularly sensitive issue because many government regulations can have an impact on the value of private property. So an extensive interpretation of "regulatory takings" can hinder a government's power to regulate. The major problem is to distinguish between a legitimate exercise of governmental discretion that interferes with the investor's property rights and a regulatory taking that requires compensation. This requires a balance to be struck between achieving the public policy goals of a regulatory regime, which could reduce property values – or values potentially generated in the absence of regulation by unregulated business entities – while preserving the value of the productive assets of those entities.

Indeed, where interference with private property rights violates the legitimate rights or expectations of owners, the State may need to provide compensation, but where a measure is undertaken as part of the right to regulate in the public interest, compensation may not be due. However, the purpose of such measures, the effective impact on foreign investors' rights or the amount of compensation that should be paid are often difficult to assess and may give rise to disagreements between investors, both foreign and domestic, and host countries. The objective of attracting foreign investment, through offering guarantees against nationalization and expropriation, must be analyzed in the context of the possible risks of disputes and costs it might involve for host countries.

Most IIAs contain provisions on the taking of property, generally defining it as including traditional notions of nationalization and expropriation as well as creeping expropriations and regulatory takings. The indirect takings may or may not be qualified by a carve-out for normal regulatory powers, such as for taxation, intellectual property rights and public debt. Furthermore, most IIAs require observance of the principal elements of a lawful taking: public purpose, non-discrimination and compensation. However, there is no uniformity regarding the standard of compensation to be paid. From a development perspective, recent practice in IIAs suggests that developing countries try to strike a balance between offering reasonable protection to investors and retaining their right to regulate.

3.3 Dispute settlement

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

National policies on investor-State dispute settlement differ (UNCTAD, 2003a: 114). Some require the exclusive use of national procedures and remedies while others require the prior exhaustion of domestic remedies in the host country before recourse to internationalized dispute settlement systems is permitted. And still others offer the investor free choice between national and international dispute settlement

The willingness of the host country to accept an internationalized dispute settlement may be motivated by a desire to show its commitment to creating a good investment climate, especially as foreign investors expect the internationalized system to be impartial and even-handed. This may be of importance where the country has followed a restrictive policy on FDI and wishes to change that policy. On the other hand, international arbitration may involve more money and time than dispute settlement by national courts.

National investment laws often expressly permit such internationalization of investment dispute resolution by enshrining investor choice in a special dispute settlement provision in the FDI legislation. But many FDI laws are silent on this. In such cases, the investor is required to use the internal legal remedies available to them under host country law. The same is true of countries that have no FDI laws. In these cases international remedies may be available under the international treaty obligations of the host country in IIAs. So a dispute settlement clause in a BIT that allows the investor a choice between national and international procedures binds the host country as a matter of international legal obligation. Such an international obligation can also be made enforceable before national tribunals where the investment contract between the investor and host country includes a dispute settlement clause that incorporates the country's international treaty obligations to allow the use of internationalized systems of dispute settlement.

Dispute settlement has evolved significantly in IIAs, many of which now include provisions on State-State disputes (relating to disputes over the interpretation and application of an IIA agreement) and investor-State disputes. Agreements differ with respect to the extent of investor choice over the applicable means of dispute settlement, but more of them now permit unilateral investor choice of method if amicable means fail to resolve the dispute. The inclusion of investor-State dispute settlements in IIAs can help the investment environment by giving some reassurance to investors that their rights can be backed up through third party procedures of dispute settlement when amicable resolution fails. However, dispute settlement cases and international arbitration can demand much in resources and expertise, possibly putting developing country parties at a disadvantage. Moreover, the trend towards internationalization of dispute settlement procedures needs to be balanced against the loss of sovereign control over dispute settlement. Local settlement might be left underused, delaying the development of local expertise, while increasing the costs.

3.4 Performance requirements

Performance requirements are stipulations imposed on foreign affiliates to act in ways considered beneficial for the host economy. The most common ones relate to the local content, export performance, domestic equity, joint ventures, technology transfer and employment of nationals. Their purpose is generally to induce TNCs to do more to promote local development – by raising local content, creating linkages, transferring managerial techniques, employing nationals, investing in less developed regions, strengthening the technological base and promoting exports. TNCs may be unwilling, for example, to use a location as an export base since it might compete with other parts of their production systems, or they may be less willing to invest in using local resources (instead of using production bases abroad), and performance requirements can induce them to explore the possibility of exporting or using local resources.

Performance requirements can be an important policy tool to enhance the benefits of inward FDI. They have been used extensively by a wide range of countries. In developed countries, they were particularly used in the 1970s and 1980s in industries in which FDI was concentrated (UNCTAD, 2003a: 119). Although their use has declined considerably, developed countries utilize other strategic trade and investment policy instruments (such as rules of origin and location incentives) to influence the trade and investment behaviour of TNCs. Developing countries use performance requirements for a number of reasons, particularly because of their desire to promote infant industries and address balance of payments problems, and seek to preserve their right to use them. However, the incidence of the use of performance requirements by developing countries has also declined and there is a shift from mandatory requirements to requirements linked to investment incentives.

The general trend towards reducing the use of mandatory performance requirements reflects several factors:

- WTO rules oblige members to abandon some measures – notably those covered by the Agreement on Trade Related Investment Measures.
- Falling trade barriers and a more competitive environment for FDI make it more difficult to impose performance requirements without increasing the risk of deterring FDI and affecting competitive performance. Thus, mandatory re-

quirements are now rarely applied in activities in which host countries are in a relatively weak bargaining position for FDI, such as efficiency-seeking export-oriented FDI. Similarly, they are less used to promote local linkages in activities that feed into exports. Countries have generally shifted from "sticks to carrots" – they use incentives to encourage foreign affiliates to operate in a way that promotes the kind of development that is desired.

- There is a growing preference among governments for more market-friendly tools to meet development objectives.

- Some of the development objectives that countries sought to promote through performance requirements may now have been realized (UNCTAD, 2003b).

Countries have to balance the potential benefits of performance requirements against the costs of creating inefficiency and the risks of deterring FDI. The evidence suggests that achieving the objectives of performance requirements depends largely on the clarity of these objectives, and the broader industrial and trade policies in which the requirements are set. Particularly relevant are strong local enterprises, flexible and well-managed institutions and policies that support local capability development. Also important is the capacity of officials to enforce requirements pragmatically, respond to changing conditions and needs and monitor their impact.

Performance requirements have received increasing attention in IIAs during the past decade or so. At the multilateral level, the WTO TRIMs Agreement prohibits certain performance requirements considered trade distorting including local content requirements, trade-balancing requirements, restrictions on foreign exchange inflows and export controls. The Agreement prohibits not only mandatory TRIMs but also those linked to an advantage. It applies equally to measures imposed on domestic and foreign enterprises. With the expiry of the transition period agreed upon for phasing out measures in developing countries and LDCs, the Agreement's provisions now apply to all WTO members except those granted an extended transition period (UNCTAD, 2003a: 120). Furthermore, export performance requirements linked to the receipt of a subsidy are restricted under the WTO Agreement on Subsidies and Countervailing Measures (SCM). Both the agreements mentioned above apply only to measures related to trade in goods.

IIAs at the regional and bilateral levels have not traditionally addressed performance requirements. But this has started to change. Some countries restrict a wider range of performance requirements than those in the TRIMs Agreement. For example, NAFTA forbids domestic equity requirements, export performance requirements (in goods and services) and requirements to transfer technology, production know-how or other proprietary knowledge for investments by investors from both parties and non-parties.

The use of performance requirements and their treatment in IIAs remains controversial. There is no consensus either on their effectiveness in helping countries to promote development, or in their distorting effects. Some host developing countries consider performance requirements to be an effective policy tool for enhancing the benefits of FDI and consider their disciplining to be undue interference with their policy space. It could be argued that, as long as governments are aware of the possible costs of performance requirements, they could be left free to use them, subject to existing international commitments.

3.5 Incentives

Investment incentives are used for attracting new FDI, preventing relocation elsewhere, or for making foreign affiliates in a country operate in certain ways or undertake activities regarded as desirable. Governments use three main categories of investment incentives to attract FDI and benefit more from it: financial incentives, fiscal incentives and other incentives (refer to Module 1, theme 3).

As noted (Module 1, theme 3), most incentives do not discriminate between domestic and foreign investors, but they sometimes target one of the two. They can also establish a difference in treatment between enterprises of different sizes or with different profiles. They can be offered by national, regional and local governments.

When considering incentives, governments need to take various cost-related aspects into account (UNCTAD, 2003a: 124):

- One risk is offering incentives to TNCs that would have invested anyway, so the incentive is a mere transfer of funds from governments to companies.

- Using existing or future public resources for incentives reduces the opportunity for using them for other purposes, such as improving the infrastructure or training the workforce (location determinants that enhance the ability of countries to attract FDI).

- Incentives give rise to administrative costs, which tend to increase as the discretion and complexity of schemes increase.
- There could be potential efficiency losses if firms are encouraged to locate where incentive-based subsidies are most generous and not where location factors might otherwise be most favourable to an efficient allocation of resources.
- Incentives may sometimes give rise to unintended distortions by discriminating, between firms that are relatively capital-intensive and those that are relatively labour-intensive, between projects of different cash-flow profiles or between large and small firms.
- Tax incentives may induce TNCs to use transfer pricing to shift profits to locations with the most generous tax conditions, eroding the tax base in several host countries.

In the context of increasing competition for FDI, the use of incentives has expanded considerably in frequency and value. However, evidence suggests that in most cases, incentives are not a fundamental determinant and could contribute to attracting FDI only if other determinants are in place. For host countries, this underlines the need to evaluate their impact on the investment decision against the costs they may involve. A useful guide in this respect is OECD's checklist for assessing FDI incentives policies.

Box 23

OECD's checklist for assessing FDI incentives policies

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

The desirability and appropriateness of offering FDI incentives

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

Frameworks for policy design and implementation

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

The appropriateness of strategies and tools

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

The design and management of programmes

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

Transparency and evaluation

15. Have sound and comprehensive principles for cost-benefit analysis been established?
16. Is cost-benefit analysis performed with sufficient regularity?

Box 23

OECD's checklist for assessing FDI incentives policies

17. Is additional analysis undertaken to demonstrate the non-quantifiable benefits from investment projects?
18. Is the process of offering FDI incentives open to scrutiny by policymakers, appropriate parliamentary bodies and civil society?

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

Source: UNCTAD (2003a: 128).

Most IIAs do not contain explicit provisions on incentives, although the principle of non-discrimination between domestic and foreign investors may apply. A major exception is the WTO Agreement on Subsidies and Countervailing Measures which may apply to subsidies granted to foreign investors if they relate to activities in trade in goods (UNCTAD, 2003a: 126-127). In general, host countries retain considerable freedom to develop and apply incentive programmes to attract FDI and increase the benefits received from it. This also gives countries considerable discretion in conducting their development policies.

3.6 Transfer of technology

The transfer and dissemination of technology and the promotion of innovation are among the most important benefits that host countries seek from FDI. As noted, TNCs are major sources of innovation and FDI is an important mode of international transfer of technology, with scope for various potential contributions towards strengthening technological capabilities in developing countries (Module 1, theme 4). But attracting TNCs with the requisite technologies and innovative capacities and mastering, upgrading and diffusing them in the domestic economy require policy support in the host economy.

First, TNCs with the most suitable technologies have to be attracted, then they have to be encouraged to transfer the technologies that offer the best potential for local development. If TNCs start with simple technologies suited to the low wage and low skill setting of many developing countries, they have to be persuaded to upgrade them as wages and skills rise. In more advanced economies, they have to be to transfer the technology development process itself, undertaking more design and R&D locally.

The development impact of technology transfer through FDI goes well beyond what happens within foreign affiliates – it extends to diffusing technology and technological capabilities to local suppliers and buyers and contributing to local innovation capacity. The need for policy support arises from the fact that markets will not by themselves optimize technology transfer for development. International technology markets are imperfect and fragmented, dominated by a few large enterprises, mostly TNCs. Once transferred, the efficient use of technology also faces problems (e.g. due to imperfections in transactions in information, weak institutions and markets, or strategies of technology suppliers).

Measures to influence technology transfer by TNCs and related technology diffusion and development in host countries span a wide range, from those affecting technology transfer through FDI to broader policies on enterprise development, skills creation, inter-firm linkages and the promotion of innovation (UNCTAD, 2003a: 129-131).

- **Direct controls**. Direct controls on technology transfer by host-country enterprises and on FDI have been implemented by many developing countries with a view to influencing the types, costs and conditions of technology transfer. They did not fully succeed largely because they did not address two issues:

  - **The information and administrative requirements of technology regulation**: it is difficult for any government to dictate effectively to private enterprises the best technology to buy, the most economical terms for procuring it and the optimal structure of transfers over time. On the FDI front, it is similarly difficult for governments to dictate which technologies to transfer or how much to restrict entry to encourage infant local enterprises. The difficulties are far greater in developing countries, where information and skills are scarcer, institutional structures more rigid and local enterprises and institutions less developed.

- **The absorption and upgrading of imported technology**: Regulations focused on the cost of the transfer, not on the conditions needed for the effective absorption and upgrading of imported technology, simply assuming that the technology would be used efficiently; this often turned out to be optimistic and imposed costs on host countries, saddling them with technological lags and inefficiencies. Moreover, the settings for implementing restrictive technology transfer policies – protected regimes that gave few incentives to firms to master and upgrade imported technologies – concealed these inefficiencies and added to the ineffectiveness of such policies.

- **Stipulating greater local ownership, or requiring transfers.** Many countries have sought to encourage technology absorption by stipulating foreign equity shareholding or insisting on minority joint ventures. The presumption was that greater local ownership would lead to better absorption and diffusion of technology. However, where imposed on reluctant technology providers, the results were often not in accordance with expectations. The strategy worked best in countries that had strong local firms, a large skills base and an export-oriented environment. It also worked in some large developing countries. The scant evidence on technology transfer requirements suggests that they too did not work well.

- **Providing behavioural incentives**. The effectiveness of incentives for technology transfer to host countries depends on the competitive environment and the capabilities of local suppliers. Where the host economy is open to competition and local suppliers are capable, incentives enhance technology transfer. Some countries used incentives not only to attract TNCs into high-technology activities but also to encourage foreign affiliates to move into more complex technologies and R&D. However, the most important factor of success was not the fact that they offered incentives, but the preconditions they created for TNCs to deepen technological activity (such as more advanced skills, better local suppliers, more active and innovative research institutions).

- **Strengthening intellectual property rights**. The strengthening of IPRs can be beneficial for some types of technology transfer, but implementing the IPR regime could be challenging and involve certain risks: for instance, in some cases stronger IPRs could increase the scope for the abuse of market power by technology owners; or they could raise the cost of technologies without necessarily stimulating local innovation or international technology transfer. However, strong IPRs are likely to benefit developing countries with an advanced industrial sector, stimulating local innovation and increasing TNC transfer of technology-intensive activities or R&D functions.

In summary, policies to regulate and stimulate technology transfer through FDI can work, but under special conditions (table 3). Where these conditions do not exist, attempts to control contracts and transfer arrangements may not produce the desired results.

Table 3

Policies to regulate and stimulate transfer of technology

Strategy objective	Policy	Policy instrument	Condition
Promote domestic technological capabilities by minimizing reliance on FDI	- Conditions on FDI - Incentives to partnership agreements - Government support to domestic firms - Foster national flagship firms	- Foreign ownership restrictions - Financial and tax incentives to local firms - Technical support, R&D promotion programmes - Effective export promotion - Encourage hiring of foreign experts, licensing and capital goods imports	- Exposure to international competition (as by strong export orientation) - Availability of skilled labour - Financial resources - Entrepreneur's willingness and ability to undertake risky technology investment - Institutions able to support skill, technology and export activity
Promote FDI with minimal government intervention in the expectation that it will involve technology transfer	- Encourage large FDI inflows - Relax FDI restrictions - Ensure macroeconomic stability	- Remove FDI restrictions or provide incentives - Liberalize trade - Foster competition and well-structured IPR regimes - Provide good infrastructure - General FDI promotion	- Efficient and credible institutions to administer market-friendly policies - High local absorptive capacity

Table 3

Policies to regulate and stimulate transfer of technology			
Promote technology transfer by FDI with proactive government intervention	- Target specific TNCs - Provide incentives for TNCs to upgrade their technologies	- Industrial parks and advanced infrastructure - Well structured IPR regimes - High level skills and strong training system geared to activities promoted - Rigorous quality standards - Targeted incentives for activities and/or firms	- Institutions able to handle incentives - Institutions able to select technologies - Institutions for technology support and skill formation
Mixed strategy	- Promote linkages with domestic economy - Build local technological capabilities - Encourage deepening of TNC activity	- Business incubators - Information clearinghouses - Industrial parks - Supporting R&D - Supporting joint ventures, licensing and collaboration - Supporting training of domestic labour force	- Institutions able to bargain with TNCs - Institutions able to plan strategically - Ability to integrate skills, financial markets, infrastructure and technological capability development

Source: UNCTAD (2003a: 132).

Overall, developing countries have moved from the direct regulation of technology transfer towards a more market-friendly approach. There are now few developing countries with comprehensive systems for vetting technology contracts, either between independent firms or between TNCs and their affiliates. Controls on inward FDI used to regulate technology transfer have declined in recent years. Most countries, developed as well as developing, now offer stronger IPR protection, although the case for strengthening IPRs in countries with a weak technological base remains in dispute. Countries are, moreover, using new policy tools to promote technology transfer and development by TNCs. These include targeting technology-intensive activities and functions by promotion agencies seeking to attract new FDI, incentives for existing foreign affiliates to upgrade technologies and undertake more R&D and the encouragement of greater local content and stronger local linkages by TNCs.

International agreements have also moved from a regulatory to a market-friendly approach. It largely treats technology as a private asset that is traded on market principles subject, to general competition rules that control abuses. The Trade-Related Aspects of Intellectual Property Rights Agreement, for example, provides rules on restrictive practices pertaining to licensing contracts.

The current approach in IIAs also accepts the potential inequality of market power between technology sellers and buyers – and that between developed and developing countries – in the market for technology. It thus includes provisions to encourage cooperation with and provide assistance to developing countries in building a technological base. It also encourages TNCs to transfer technology and innovative capacity to developing countries. For example, the OECD Guidelines of 1976 noted the need for TNCs to transfer innovative activities as well as technology to developing countries, to help diffuse technology locally, and to grant licenses on reasonable terms. Various IIAs and agreements concluded by the EU with developing countries also encourage technology transfer. Perhaps the best example is the TRIPs agreement, which, while protecting the interests of technology sellers by strengthening IPRs at the international level, stipulates that "developed country members shall provide incentives to enterprises and institutions in their territories for the purpose of promoting and encouraging technology transfer to least developed country members in order to enable them to create a sound and viable technological base". Such provisions indicate recognition at the international level that there is a need for preferential treatment for developing countries in the technology transfer process and give support to national policy efforts with respect to technology transfer and development.

3.7 Competition policy

Where countries choose to open their economies and, as part of this process, remove the screening of FDI at the point of entry, competition policy acquires special importance as part of the policy framework for FDI. Host countries want to ensure that the reduction of regulatory barriers to FDI and the strengthening of standards of treatment of foreign investors are not accompanied by the emergence of private barriers to entry and anticompetitive behaviour on the part of firms (UNCTAD, 2003a: 134). The main objective of competition policy is to preserve and ensure the efficient allocation of resources in an economy, resulting in the best possible outcome in terms of quality, price and quantities of goods and services for consumers.

Competition policy deals, with the anticompetitive effects of restrictive business practices, the abuse of dominant positions and M&As each present different issues and challenges for developing countries and is of particular relevance in the context of FDI and TNC activities.

- **Restrictive business practices** refer to acts or behaviour of enterprises that limit access to markets or otherwise unduly restrain competition, thus having or are likely to have adverse effects on free competition in those markets. The control of restrictive business practices is a major issue for developing host countries: Restrictive arrangements by TNCs (such as a parent company setting limits on the external markets of its individual affiliates) can limit the positive developmental impact of FDI by undermining the capacity of the market to regulate the activities of the economic actors.

- A **dominant firm** may engage in restrictive business practices in order to maintain or increase its position in the market, with the effect of reducing competition in that market (abuse of dominant position). An enterprise is in a dominant position when, either by itself or acting together with a few other enterprises, is able to control the relevant market for a particular good or service or group of goods or services (for example, a company in a dominant position can impose unfair or discriminatory commercial terms upon suppliers and/or distributors). TNCs are often in dominant positions or acquire such positions through M&As.

- When the entry of foreign investment is made through **cross-border M&As**, there is a greater probability of anticompetitive effects because the number of competitors may be reduced. Therefore, countries tend to screen those transactions and often regulate them both at the entry and post-entry phases. Regulation at entry considers the potential market effect of the acquisition of a local company by the foreign investor on competition in the host country industry, where the foreign investor may acquire sufficient market dominance to warrant such review. The control of potential post-entry competitive behaviour may be necessary to deal with the conflicting objectives of effective competition and local capacity building.

Developed countries were the first to adopt competition laws and set up regulatory agencies. In 1980, fewer than 40 countries – mostly developed countries – had competition laws. By 2003, the number reached 93. Many developing countries and economies in transition have adopted competition laws as well and set up agencies to administer them (UNCTAD, 2003a: 135).

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

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

A host country can, however, limit the application of its competition policy when the expected benefits outweigh the welfare loss due to anticompetitive effects – for example, nurturing particular enterprises, or new and innovative R&D – by providing temporary protection and exclusivity. However, exceptions need to be treated with care, so that they are not maintained if no longer unwarranted by market conditions.

Most IIAs do not cover competition issues and hence the question of the interaction between national and international policy does not arise in connection with policy measures to ensure competition in host economies. It is usually assumed that the international element of competition law and policy are dealt within a separate specialized instrument. At the multilateral level, the only such instrument is the 1980 UNCTAD Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices. This instrument stresses the close relationship between the control of restrictive business practices and development policies. In recent years, however, a trend has arisen in free trade agreements covering, *inter alia*, investment matters to also regulate anti-competitive practices (see also UNCTAD, 2004b). There has also been gradual adoption of competition policies administered by a supranational competition authority by regional economic integration organizations (REIOs), including the EU, MERCOSUR, the Caribbean Community and the Economic Community of West African States (ECOWAS).

4 Investment promotion

As competition for FDI increases and investors become more selective, countries use various promotional policies to attract investors. Investment promotion can refer, in some contexts, to a wide range of initiatives of a host country to encourage investment; thus, it can include business facilitation measures such as incentives as well as a range of other instruments. The general investment promotion schemes of home countries can be grouped into three main categories; (a) information provision and technical assistance, (b) fiscal and financial incentives, and (c) political risk insurance. However, in what follows, investment promotion is considered in a stricter sense, as the communication of information and opportunities to investors and the process of convincing those investors to invest. Other aspects of business facilitation, including incentives and various improvements in the business environment are discussed elsewhere in this handbook (Module 1, theme 3). Unlike many of the other core FDI policies that are shaped at the national as well as international level and raise issues of interaction between the two, as discussed in the preceding section, investment promotion, in the stricter sense described above, is shaped mainly at the national level.

Information on what investment decisions are based on is not perfect and subjective perceptions matter. Thus, good marketing can make a difference, but only if basic determinants are in place. A large and dynamic economy needs to promote itself less than a small and less dynamic one. The bulk of the massive inflows into China, for example, are not necessarily the result of active FDI promotion. On the other hand, if the economic base is weak or unstable, promotion alone will not be able to attract large and sustained FDI inflows. Similarly, if other elements of the investment climate, such as infrastructure or support institutions, are lacking, investment promotion may not make much difference.

4.1 The three generations of investment promotion

Investment promotion has grown in importance and scope over time. Its evolution has been described in terms of three generations of investment promotion (box 24):

- The **first generation of investment promotion** simply relied on the liberalization of FDI regimes, seeking to attract FDI through the global promotion of the host country's locational advantages.

- In the **second generation of investment promotion** governments went further and tried to attract FDI by 'marketing' their countries. This approach typically finds its expression in the establishment of national IPAs. By the beginning of 2008, the WAIPA, established in 1995 included 220 IPAs from 154 countries, representing cities, regions and countries from all over the world (WAIPA, 2007: 21).

- The **third generation of investment promotion** takes the general enabling framework of FDI and a proactive approach towards attracting FDI as a starting point. It then proceeds to target foreign investors at the level of industries and firms and in the light of the country's developmental priorities. The objective is to match the locational advantages of a country, as well as its development objectives, with the competitive advantages and strategic orientations of firms. A critical element of such investment promotion is to improve – and market – particular locations to potential investors in specific activities. However, such a targeted approach, especially the development of locational "brand names", is difficult and takes time. It requires fairly sophisticated institutional capacities. Third generation promotion is nevertheless growing in practice, as witnessed by the proliferation of subnational agencies (of which there are currently at least 240) and even municipal investment promotion agencies.

Box 24

Investment promotion: a historical view

Initially, the main method of attracting FDI was through general promotion of the comparative business and trading advantages of potential host locations. Starting in 1980, most developed nations had introduced major FDI promotion and marketing campaigns; and by 2000 only a few of the emerging economies had not launched similar initiatives. Many countries developed FDI marketing and promotion not only through national IPAs, but also at the level of regions, cities and even smaller areas. In this competitive and crowded marketplace, general economic promotion to potential investors was no longer as effective in generating

Box 24

Investment promotion: a historical view

new capital inflows; nor did it remain the best means of identifying and building sustainable investment and business partnerships between investors and their new host locations.

To address this challenge, there has been a move towards the targeting of investment opportunities at specific economic sectors; at relevant companies within these sectors; and at the appropriate decision-making groups and individuals within those companies.

Source: UNCTAD (2007).

The most commonly used measures and techniques were developed during the first and second generations of investment promotion. They include the use of communication and marketing techniques such as advertising, public relations and events, usually in a non-specific and broad manner, to build an image of the host country, generate FDI, and various services to facilitate and retain investments (Module 1, theme 3). The third generation strategy adopts measures and techniques that focus on a defined group of sectors, firms and individuals – the targeted investment promotion approach. These are discussed in the next section.

4.2 Main elements of targeted investment promotion

Targeted investment promotion, comprising a range of policies and measures that make up what has been called third generation investment promotion, is an integral part of national FDI policies that act as a link between national economic development priorities and the global community of TNCs and other private investors. Targeting is a means for gaining the attention and interest of international investors through developing and confidentially promoting specific investment projects, which may be of commercial interest to those investors and which are considered by the host country as desirable for its development.

Investors pass through a number of steps when making a foreign investment. Broadly speaking these are:

- Consideration of investment and choice of location;
- Making the investment;
- Managing the investment (including an exit strategy and/or reinvestment).

Targeted investment promotion intervenes proactively at each of these steps. In order for IPAs to play an active role in investor targeting, they should possess:

- A sound understanding of the investment and location decision process by TNCs;
- Concepts and tools to develop an investor targeting strategy;
- Skills for communication to influence investor decision-making.

At the core of investment targeting skills is an understanding of the client group – the international investors who will bring the capital, skills, technologies and knowledge needed to help the host economy grow and develop. These international investors view their market priorities differently from IPAs that are promoting the location. Hence, successful targeting requires the promoter to understand market and investment opportunities through the eyes of the investor. The more closely the promoters can identify the priorities of an investor, the more likely they are to respond to them through appropriate projects and promotional actions.

The speed, sophistication and technical aspects of the decision process vary greatly between companies. All are seeking to reduce the time taken and costs involved in moving from investment decision to action. The pressure upon corporate executives to gain first-mover competitive advantage, for instance, is one business factor that can be addressed by IPAs through investor targeting. However, such objectives require strategic tools to be put into practice, as well as communication skills to make sure they effectively reach the targeted investors.

Targeted investment promotion combines two core areas: first, investor targeting and second, use of techniques for location marketing or promotion, focusing on specific industry sectors and firms (investor communication).

- **Investor targeting** is in part a process of screening. It starts with a wide range of possible investors, sectors and projects; then, through a coherent logical process ranks the alternatives and leaves behind a smaller group of variables, based on the assessment of their potential benefits according to the established development objectives. Each step on the way screens out more and more possibilities until there is a manageable number of prospective investors left who can then be approached or order to introduce and negotiate investment. There are five main principles that define targeting and distinguish it from more general investment promotion (box 25).

- **Investor communication** directly follows investor targeting. After having established a list of target investors to contact, the next step is to communicate with them with the aim of promoting the location. Creating a strategic communication plan is a key phase in this process. If a country has adopted investor targeting as its core strategy of investment promotion, then it needs targeted investment-marketing techniques to reflect that strategy and make it effective. To obtain a series of influences on the potential investor, IPAs may use various tools and techniques comprising advertising, direct marketing, public relations, the internet, in-house media events, networking, direct contact, opening foreign offices or embassy networks. Some of these tools, such as direct communication and the use of the internet, usually combine a high probability of influencing the investment decision with being cost-effective.

Box 25

Principles of investor targeting

Targeting is a strategic approach to attracting FDI through a carefully planned process involving the following:

Active identification of specific investment projects: The prime distinguishing feature of targeting FDI is that it is a promotion process initiated and delivered by the national IPA usually in partnership with ministries, the diplomatic service and the national private sector business organizations. The rationale for this pro-active approach is that investment projects should match the country's needs and capabilities.

Careful planning and management of investor search programmes: A second distinctive feature of investor targeting is that it is a planned process of identifying sectors, companies, projects and potential benefits associated with the presence of international investors in the host country. The main steps and tasks required to pursue targeting should be clear, capable of being planned, and undertaken by a national team once it has had direct advisory and mentoring support in this respect. A necessary condition is to critically test every assumption during the research and analysis stages; to secure a range of information inputs as wide as possible; and to plan targeting by taking into consideration the perceptions of international investors. Investor targeting requires project planning as well as project management skills and techniques, in the same way a TNCs needs specific skills and techniques for its strategic planning and business development. The planning of investor targeting should be a mirror image of that undertaken by investors.

Investigation of specific corporate priorities: A third feature of targeting is that it involves promoting an investment project that meets the business priorities and processes of a specific company. It is not simply meeting with a company to suggest "Why not to come and invest in my country?", but rather preparing a thoughtful response to specific concerns of the company. The key requirement is to identify and understand the real business objectives, priorities and orientations of the target company; and then to provide a carefully considered investment proposition that matches with these aspects.

Confidential promotion to specific corporate executives: A fourth feature of investor targeting is the objective of professionally presenting a specific relevant investment proposition to a specific corporate executive (or group of executives) having the authority to approve investment in such projects. It is not a general promotion to a corporate public relations representative, but a negotiation process with the person who can make the necessary commitment. An essential aspect of this promotion is that it must be undertaken on a confidential basis, and it may be that a signed confidentiality agreement between the IPA/advisory team and the company will be required to protect the interests of both parties. Confidentiality is important for both the IPA and the corporation.

Delivery through a single agency leadership, management and coordination: Another distinguishing feature of investor targeting is that it is planned, undertaken and managed by and through a single agency having a mandate and the resources required in this respect. It is a "single team" approach akin to the "single window" best practice feature of IPAs, encompassing key experts from other public and private sector organizations. The active targeting team normally has a remit for one or perhaps two sectors; it includes people with direct experience of the sector and with a mix of business and government skills; it can be located in or associated with the national IPA, but it may also be within a national economic development agency.

Source: UNCTAD (2007).

Investor communication can concern two main types of activities:

- **Image building** in investment promotion in general refers to the focused and sustained efforts of a country to define and inform international investors about its features as a possible destination for FDI. The purpose of image building in targeted promotion is to change the perceptions of investors in the target sector, or even the perceptions of individual targeted investors, from negative to positive or from unaware to aware, and to maintain or improve those perceptions once changed. General image building can be done by diplomatic staff, for instance, or by IPAs in the framework of image building campaigns. Targeted image building requires specialized expertise such as the familiarity with the sector and the needs of individual investors.

- **Investment generation**. In the third generation of investment promotion, investment generation forms the key challenge of investor communication. The main objective of investment generation is to persuade the investor to decide to invest in a location. At that point, it "hands over" partly to investment facilitation. Investment generation seeks to increase the number of times a location is placed upon the short list or is the preferred location of an investor; however, if there are many short listings but little investment in the end, this points towards excellent communication but a problem in the facilitation area.

Targeting and initial investor communication is usually followed by enquiries, investment facilitation and management of investor relationships within the framework of corporate development support.

- Promoters receive **enquiries** from interested investors, often as a result of their investment generation and image building activities. Once an enquiry has been received, IPAs should do some basic research on the enquiring company, be able to distinguish between different types of enquiries, identify their objectives and treat them accordingly.

- The key objectives of **investment facilitation** are to ensure the entry of investment into the location, to make sure the investment is fully completed (and not cancelled), to make sure that the investors are satisfied and to encourage reinvestment. Investment facilitation refers to a detailed "road map" for assisting the investor in each phase of the investment process, from visiting a site to checklists of the necessary approvals, legal advice or other services. Investment facilitation will also help build the image of the location as an investment destination – a satisfied investor is a very effective promotional tool (box 26).

- Maintaining a strong relationship with existing investors is very important for stabilizing new investment, encouraging reinvestment and creating a favourable image about the host country's investment climate. **Corporate Development Support** (CDS) is the emerging standard term among IPAs for what was known as "aftercare", namely the continuing support to executives and managers in TNCs and other foreign companies following their first investment in a new host location.

Box 26

Denmark – the promotional value of a happy investor

The Danish investment promotion agency, *Invest in Denmark*, uses satisfied investors as a promotional tool. The homepage of *Invest in Denmark* lists an array of statements from various international investors, which describe their reasons for investing in Denmark. Similar cases are used in the same way in the different brochures and promotional material that *Invest in Denmark* disseminates.

The emphasis is put on Denmark's factor endowments rather than on what the investment promotion agency has to offer. The different investors point to various advantages, such as location and infrastructure, market access, cluster advantages, workforce and level of education.

Altogether, 36 investors have contributed their comments to the "why Denmark" section on the website. Existing investors are also invited to take part in seminars held by Invest in Denmark, which typically feature the presentation of case studies, which describe certain company experiences in locating and operating in Denmark.

***Invest in Denmark* is convinced that statements by investors constitute the best possible argument in favour of Denmark as an investment location. This was confirmed in a survey in which the existing investors were asked about their motives for investing in Denmark. Furthermore, *Invest in Denmark* emphasizes the importance of**

Box 26

Denmark – the promotional value of a happy investor

the bandwagon effect, whereby the potential investors are influenced by other companies' choices to invest there. Major industrial players – such as IBM in the information technology sector – or key Danish companies play an important role in convincing the investor of the favourable business environment.

Source: UNCTAD (2001: 28).

According to surveys by UNCTAD, IPAs use a variety of techniques and tools to achieve their objectives. However, investment promotion is relatively new and it is characterized by rapid change. In most countries, whether they rich or poor, IPAs are witnessing a number of challenges in trying to refine their efforts to attract FDI, in terms of costs, institutional capacity, experience or skills. To ensure successful investment promotion, several main categories of practices can be used:

- Investor targeting by region and industry;
- Investor targeting by type of investment;
- Services provided to investors;
- Promotional tools;
- Performance evaluation;
- Best practice guidelines for investment promotion.

Details and examples of practices under each of the above categories can be found in the annex.

5 Good governance and investment promotion

In the competition for FDI, many governments have been engaged in marketing their countries, often through IPAs. As governments and IPAs focus on attracting FDI, comparatively less attention may be given to improving the national business environment and to the general measures that affect business, including FDI, within countries. As a result, investors persuaded by IPAs to invest in new locations are often confronted with unanticipated administrative obstacles. As many of UNCTAD's Investment Policy Reviews point out, this is true especially in developing countries, where lack of efficiency and capacity within the public sector contributes to bureaucratic red tape, unexpected delays and poor services.

Four elements are crucial for good governance in investment promotion (table 4): predictability, accountability, transparency and participation.

5.1 Predictability

Predictability is perhaps the most important concern for investors. They evaluate new projects by, *inter alia*, the risks involved, and a high degree of uncertainty can easily be a deterrent. Clear policies and a comprehensive legislative framework are therefore essential, along with the consistent application of laws and regulations.

- In order to be predictable, laws and regulations should set out the criteria by which government officials make decisions. The clearer the standards of application, the greater the degree of predictability and smaller the risk for an investment. In the absence of – or in addition to – a comprehensive legislative framework on investment, some countries have established a system of case-by-case negotiated agreements (State contracts) between investors and the government. If the decision is made to regulate, there is a need for coordination and cross-checking with related laws, regulations and policies to ensure consistency.

- Where lack of consistency arises, government regulators should consult with stakeholders and try to resolve the problem. In addition, laws that are no longer appropriate may not be enforced.

- Governments should also ensure simplicity in rules and regulations, including the removal of unnecessary steps and procedures and the reduction of the number of documents that need to be completed. Results of a World Bank survey in 2004 showed that, in 130 countries covered, heavier regulation is associated with higher costs and delays for investors, as well as corruption (World Bank, 2005: 13). However, in a number of countries, especially LDCs, bringing simplicity to regulations is not the only challenge. Increasing institutional capacity in government agencies at the national and subnational levels is equally important.

Table 4

Ingredients of good governance in investment promotion		
Elements of good governance in investment promotion	**Examples of how to improve governance**	**Mechanisms/instruments/practices**
Predictability	• Clear policies and a legal framework for investment • Streamlined and simple rules and regulations governing investments • Effective investment facilitation services	• Strong advocacy role of IPAs • Online road maps for investors • IPA investment implementation • Support services
Accountability	• Introduction of ethical standards for civil servants • Anti-corruption instruments and measures • Dispute resolution mechanisms for investors	• Code of conduct • Client charters • Anti-corruption legislation and enforcement (Anti-corruption Board) • Investment Ombudsman
Transparency	• Easy availability of information for investors • Timely disclosure of information on changes in the investment regime • Information collection and sharing of national data on FDI and the impact of international investment on the economy	• Investment regime data on the Web • Investment guides • Online application and tracking system for permits and licences • Client charters • Analysis of FDI data by IPA and frequent publications on FDI trends and impact
Participation	• Regular public/private sector dialogue on efforts to improve the investment environment • Consultations with civil society on legislative and regulatory changes that will influence businesses	• National Business Council • Involvement of NGOs and labour organizations in consultations on policy decisions

Source: UNCTAD (2004a).

In cases where the approach towards good governance in formulating the legal and regulatory framework is not followed closely to provide clear and predictable policies, rules and practices, the consequences for investment promotion are often negative.

First, laws that are too costly to comply with, or too complicated to understand, could encourage disrespect for them, as well as corruption. Second, the confusion created could lead to uncertainty and affect the decision to invest. Lastly, this would mean misallocation of resources, both for investors and countries, as time and energy would be diverted to costly implementation efforts – and comply with – unnecessary regulations.

5.2 Accountability

When discussing the issue of accountability of government institutions and their employees who deal with investors, it is important to identify to whom and for what these civil servants are accountable. Civil servants are accountable for applying and enforcing specific sets of laws, regulations and policies, and they are legally bound to do so. To ensure that these tasks are performed correctly and to prevent corruption, it is necessary not only to have clear standards of application, but also to have in place adequate sanctions and means to detect offences. This could be achieved by anti-corruption legislation, including mechanisms to inspect reported cases.

There are, however, other issues that need to be addressed aside from legal accountability.

- A very significant one is **attitude**. Many civil servants in ministries and other government bodies still do not see investors as parties to whom they are accountable to for prompt, competent and impartial performance of their duties.

- Accountability problems also arise when it is not clear who is **responsible** for making a decision. A common complaint by investors is that they have been given “the run around” and bounced from office to office, with no one willing to address their problem. In such cases, there is a need to initiate a change of attitude and to improve job performance.

- Another important issue is related to possible difficulties that investors may face in **solving disputes with government institutions**. The establishment of an effective mechanism to resolve these disputes outside the formal court system that would save investors efforts, time and money can make an investment location more attractive.

5.3 Transparency

It is important to ensure that the text of a law or regulation is easily available to those to whom it is primarily addressed. One problem faced by foreign investors in some countries is that laws are enacted in a local language that is not spoken at the international business level. Having authoritative investment guides in internationally used languages that bring together in one publication the basic requirements for setting up and operating a business in a country is one way to address this problem.

Information technology and the internet are effective tools for increasing transparency in the investment regime and informing investors and the public of expected changes in laws, regulations and procedures. The internet could also be used to provide online question and answer services and to consult investors on new legislation and policies. The survey by UNCTAD mentioned earlier points out that in 2000, 40 per cent of IPAs were providing online services and that most IPAs maintained specialized databases on the business environment, investors, useful contacts, etc. (UNCTAD, 2001). However, it should be noted that there are major differences between countries and that in this particular survey one third of the LDC IPAs were not connected to the World Wide Web, while two thirds did not have a homepage.

5.4 Participation

The challenge for host countries is often to put in place a regulatory framework that strikes the right balance between promoting business growth, investor confidence and competitiveness, and maintaining necessary health, safety, security, environmental and labour standards. What is critical to note is that this requires a government-private sector partnership. On the one hand, policy makers, regulators, legislators and enforcers must examine the legislative process and be accountable for the consequences of the regulations that they make, both direct and indirect, positive and negative. On the other hand, the private sector could share the responsibility by answering questions when consulted and by adopting self-regulatory measures, wherever possible, such as codes of business conduct or corporate governance principles.

- For governments, consultations with the private sector about policies, laws and processes can be an important part of their investment promotion efforts. It not only keeps the government informed of investors' needs, but also signals to the business community an open and investor-friendly government.

- Apart from the investors, the government needs also to maintain a dialogue with other stakeholders, before, during and after the policy is developed and legislation is enacted. Given the critical role that civil society can play in the promotion of good governance, its role in investment promotion cannot be underestimated.

- The media also has a role to play, as monitor of government activity and as a major channel of information to the public.

In some countries, consultations between the public and private sector on investment-related issues are not carried out in formal settings, and investors therefore find that they are not consulted as frequently as they would wish on policies and measures that affect business. This is sometimes due to the weak and fragmented organization of the private sector. In order to improve clarity in the consultative process, it is generally recommended that open and formal consultations be conducted with private sector umbrella organizations. Many governments are now following this approach (box 27).

Box 27

The Tanzania National Business Council

The Tanzania National Business Council (TNBC) held its inaugural meeting on April 9, 2001. Chaired by the President, it is aimed at providing the private sector, including foreign investors, with access to the President in order to discuss barriers to efficient business operations. Membership is divided equally between government representatives and private sector leaders and NGOs. Private sector organizations include the Confederation of Tanzania Industries and the Tanzania Chamber of Commerce, Industry and Agriculture.

The TNBC lobbies for private sector concerns to be kept visible and at the forefront of the government agenda, ensuring continuing support for market reform and private sector development at the highest levels of government. Follow-up action on the issues discussed at TNBC meetings is critical, hence its links with other government bodies, for example the National Investment Steering Committee.

This Committee is responsible for identifying and resolving legal, regulatory and administrative barriers to investment and for addressing legal and administrative issues involving two or more ministries or government agencies.

Source: UNCTAD (2002: 66-77).

Developing countries, especially LDCs, that have embraced public service reforms and are committed to improved public governance, are confronted with an important task and hindered in their efforts due to limited resources and capacity. Public reform programmes take time to have an impact on all branches of government and often do not reach some parts of the administration. It is for this reason that some developing countries have requested international support in their efforts to improve public governance. International interventions in specialized areas, such as investment promotion and protection, can make use of best practices in other countries and can benchmark performance against locations that compete for the same FDI, as many ingredients of good governance can be essential in the process of attracting FDI.

6 Conclusion

Governments in developing countries and economies in transition use a range of policies and measures to attract foreign direct investment, benefit from it and address concerns about its impact. Key issues national policy makers face include, among other things, those relating to national treatment of FDI, expropriation and other regulatory takings and dispute settlement. As these and other issues are addressed in national policies as well as international agreements, their possible interaction must also be considered. Investment promotion is one of the main components of host countries' policy efforts at the national level and it increasingly follows a targeted approach.

However, efforts to formulate a regulatory framework and to promote foreign direct investment have to be coordinated with the improvement of the national business environment in order to make sure that they attain their objectives. Good governance in investment promotion is essential for putting into practice, in a coherent manner, the investment-related national policies of a host country.

Exercises and questions for discussion

1. Name the main ways in which a country can attract FDI. Give examples from your country or region.
2. In groups, discuss the possible impact on TNC behaviour of mandatory versus non-mandatory measures implemented by a host country in order to benefit from FDI.
3. What are the main concerns about FDI that national policies of a host country must address?
4. Find cases from your country or region in which FDI has raised concerns regarding its negative effects, and discuss the host country's policy response to those concerns.
5. Describe and explain the evolution of national FDI policies from the 1990s onwards. Discuss in groups the evolution of FDI-related policies in your country.
6. What are the main development concerns that a host developing country should take into consideration in its national policy regarding national treatment granted to foreign investors? Discuss these aspects in two groups: from the point of view of the foreign investors and from the point of view of the host country.
7. What is the major problem today concerning takings of property? What are the main implications for a host country?
8. Give one reason why a foreign investor might prefer international dispute settlement and one reason why national courts might be preferred to international fora.
9. Name the main advantages and risks involved in the use of performance requirements, from the point of view of the host country.
10. Name the main policy aspects that a host country would need to consider when granting incentives to foreign investors.
11. Using box 23, discuss in groups the possible ways of assessing incentives policies.
12. What measures can host countries take to encourage technology transfer by TNCs and related diffusion and development of technology in their economies?
13. Using table 3, discuss in groups the host-country conditions needed for policies in the area of transfer of technology to be effective.
14. What are the main aspects of national competition policies? Discuss in groups their role in countering possible negative effects of FDI.
15. Define investment promotion and discuss in groups its historical evolution.
16. Name three key requirements needed for an IPA to conduct a successful targeted investment promotion.
17. What are the two core areas of targeted investment promotion? Discuss the links between them.

Exercises and questions for discussion

18. Using box 25, answer the following questions:
Why should investor targeting imply the participation of host country authorities and private sector business organizations?
What skills are needed for the planning and management of investor targeting programmes?
In your opinion, how can IPAs identify the objectives, priorities and orientations of the target company?
Why is confidential promotion necessary?
Explain why, in your opinion, a single entity and a single team managing the relationship with foreign investors are important in the investor targeting process.

19. Discuss the role IPAs can play after foreign investors become operational in the territory of the host country. Give examples from your country or region.

20. Name and discuss the main ways in which a country can ensure the predictability of its investment framework.

21. In your opinion, what are the main expectations of a foreign investor in terms of accountability?

22. Explain why transparency is important in the eyes of a foreign investor.

24. Practical exercises

Individual work: SWOT analysis in investment targeting

The techniques of Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis can be used in the investor targeting process, as well as in the analysis of a location's image, by IPAs or in the frame of governmental efforts to attract FDI. One of the initial tasks in preparing an effective investor targeting strategy and action plan is deciding upon the areas of strengths and weaknesses of an economy, as well as on the opportunities and threats that foreign investors might face. The starting point for this is a SWOT analysis of the national economy. The end point is a list of target sectors for investment promotion, as well as further propositions to improve existing conditions.

You are asked by your country's Minister of Industry to provide a brief analysis of your country's attractiveness to potential foreign investors, with the view of preparing a meeting with the representative of TNCs from various industries that might be interested to invest in your country. Your tasks are the following:

- List the five most important strengths and the five most important weaknesses of your country in economic terms in the eyes of potential international investors (e.g. abundance of natural resources or weak infrastructure).
- List the five most important economic and market opportunities potentially available to international investors, as well as the five most important economic and competitive threats that might adversely affect the attractiveness of your country in the eyes of potential international investors (e.g. an increase in long-term demand for the natural resources, or the emergence of new, better resourced competitor nations in your region).
- Prepare a background note explaining to the Minister your arguments for choosing each one of the items above.
- Using the matrix below, prepare suggestions and proposals concerning possible policies and measures that might address the listed items.

Capitalizing on STRENGTHS:	**Eliminating WEAKNESSES:**
1. 2. 3. 4. 5.	1. 2. 3. 4. 5.
Improving OPPORTUNITIES:	**Monitoring THREATS:**
1. 2. 3. 4. 5.	1. 2. 3. 4. 5.

Exercises and questions for discussion

Group work

- Group 1 represents your country's national association of foreign investors;
- Group 2 represents the IP;
- Group 3 represents your country's inter-ministerial committee on investment.

Phase 1: Using table 4 in the handbook as well as the outcome of the individual work in part 1 of the exercise, group 1 discusses and identifies the main expectations of the foreign investors in your country with respect to the business environment (in terms of the elements required for predictability, transparency etc); in the meantime, groups 2 and 3 identify each member's responsibilities and divide tasks between them.

Phase 2: Group 1 communicates its expectations and requirements to groups 2 and 3.

Phase 3: Using table 4 in the handbook as well as the outcome of the individual work in part 1 of the exercise, group 2 identifies ways in which the host country could respond to the foreign investor's possible expectations; group 1 also prepares a list of concrete measures that would satisfy the investors' expectations and classify them in order of their importance; group 3 identifies the main challenges and costs (in terms of funds, timeframe, human resources, etc.) for responding to investors' expectations and decides upon the measures that can be implemented.

Phase 4: Group 2 and group 3 discuss together to reach a common decision; group 1 establishes a strategy for negotiation.

Phase 5: Group 1 negotiates with group 2 and/or group 3 either separately or together (depending on the common decision of groups 2 and 3 in phase 3).

The purpose is to match the expectations of the investors with the propositions of the host country, as far as good governance is concerned.

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Theme 2
International rules on FDI

INTRODUCTION

The past few decades have seen a proliferation of IIAs, at the bilateral, regional, and interregional levels. The number of BITs and bilateral DTTs has increased continuously. Added to that, economic integration agreements within and between regions, as well as free trade agreements (FTA), investment issues among others. While efforts to create comprehensive rules for FDI through a multilateral agreement have failed, there are, nevertheless, a number of multilateral agreements dealing with specific aspects of investment.

Along with their growth in number and expanding geographical scope, IIAs are becoming increasingly sophisticated and complex in content. As a result of the proliferation of IIAs with differing geographic scope and coverage, countries – and firms – have to operate within an increasingly complicated framework of multi-layered and multi-faceted investment rules with overlapping obligations and commitments as well as gaps in its coverage. This has given rise to an increase in investor-State dispute settlement (ISDS) cases.

In this context, developing countries face the particular challenge of ensuring coherence between national and international policies with respect to FDI, maintaining national policy space in the face of those commitments and incorporating the development dimension into IIAs.

At the end of this theme, students should be able to:

- Understand the nature of IIAs and the main types of IIAs;
- Understand the evolution of and recent trends in IIAs; and
- Understand the concept of policy space within the context of ensuring coherence between development objectives, national policies and international commitments.

HANDBOOK

1 Types of International Investment Agreements

1.1 Nature, purpose and typology of IIAs

International investment agreements can help improve countries' investment policy environment, and in so doing, help attract FDI that is conducive to economic growth and sustainable development.[20] In pursuing their economic policies and development strategies, nearly every country has entered into one or more IIAs.

IIAs are agreements between States that address and regulate various issues related to international investment including FDI. IIAs typically apply to investment by a national (an individual or a legal entity) of one country in the territory of another country. Consequently, the rules they establish affect three parties:

- The investor making an investment in a country other than his/her country of origin (foreign investor);
- The country of the investor (home country);
- The country where the investment is made by the foreign national (host country).

The terms "agreement" and "treaty" generally denote binding international instruments and the two terms will be used interchangeably in the following text. Besides IIAs, which are legally binding, there are a number of non-binding international instruments that concern international investment. Examples include declarations of principles and guidelines. The term "instrument" covers both binding and non-binding arrangements.[21]

IIAs usually focus on the treatment, promotion and protection – and sometimes liberalization – of international investment, especially FDI. Agreements may vary in this respect, depending on their type and the purpose of the agreement. For example, BITs focus mainly on protection, treatment and dispute settlement, while regional trade and investment agreements generally aim at creating more favourable conditions for investment. They do so by liberalizing rules regarding entry and operations.

According to the number of countries involved, as well as the form of participation, IIAs may be:

- **Bilateral** (between two countries; or between an organization of countries[22] and a third country);
- **Plurilateral** (between a limited number of parties): this is the case, for instance, with regional agreements; however, not all plurilateral agreements are regional (see below the case of WTO agreements);
- **Multilateral:** not limited to certain countries/regions and with the possibility of inclusion, provided the rules of the agreement are accepted, of all parties.

In the context of the WTO, a multilateral agreement is one that is agreed on by all WTO members, for example the General Agreement on Trade in Services. A plurilateral agreement is one to which only some WTO members have agreed, and which only applies among those members. Examples are the Government Procurement Agreement and the Agreement on Trade in Civil Aircraft.

With regard to substantive issues covered, IIAs can be classified as follows:

International agreements dedicated exclusively or primarily to investment

- Bilateral investment treaties: investment agreements between two States – practically all countries have concluded such agreements;
- Regional agreements on investment: investment agreements between several States from the same region – for example, the Association of Southeast Asian Nations (ASEAN) Common Investment Area or the Common Market for Eastern and Southern Africa (COMESA) Common Investment Area;
- At the multilateral level, there is no agreement in force that deals exclusively with investment, although there were several initiatives in this regard, such as OECD's draft Multilateral Agreement on Investment (MAI).

Other international agreements that concern investment

- Bilateral agreements in fields related to investment, such as double taxation treaties (DTTs aim at avoiding that the same income be taxed by two or more States);
- Bilateral or regional agreements dedicated to a broader range of issues among which investment is one, such as Economic Integration Agreements (EIAs) or FTAs;

[20] See UNCTAD (2009e).

[21] See subsection 1.5 on multilateral agreements.

[22] See subsection 1.4 for a brief discussion of regional economic integration organizations.

- Multilateral agreements in certain sectors, which also cover investment, such as WTO's General Agreement on Trade in Services or the Energy Charter.

Contracts between a State and a foreign investor (State contract)

A common mode of entry for foreign investors, especially into developing countries, is through the making of a **foreign investment contract with the State or a State entity.** A "State contract" can be defined as a contract made between the State, or an entity of the State[23] and a foreign national or a legal person of foreign nationality. State contracts can cover a wide range of issues, including loan agreements, purchase contracts for supplies or services, contracts of employment, or large infrastructure projects.[24]

The various types of IIAs negotiated between countries result in international investment rules that are multifaceted and differ in geographical scope and coverage, forming a "spaghetti bowl" of international investment relationships (figure 22). Some of them address only certain aspects of FDI policies (e.g. pre-establishment or cooperation). Others address investment policies in general, including policies that affect both domestic and foreign investors (competition rules or anticorruption measures). Still others cover most or all important elements of an FDI framework, ranging from admission and establishment to standards of treatment to dispute settlement mechanisms. Rising in number, IIAs have created an intricate web of commitments that partly overlap and partly supplement one another, creating a complex set of investment rules.

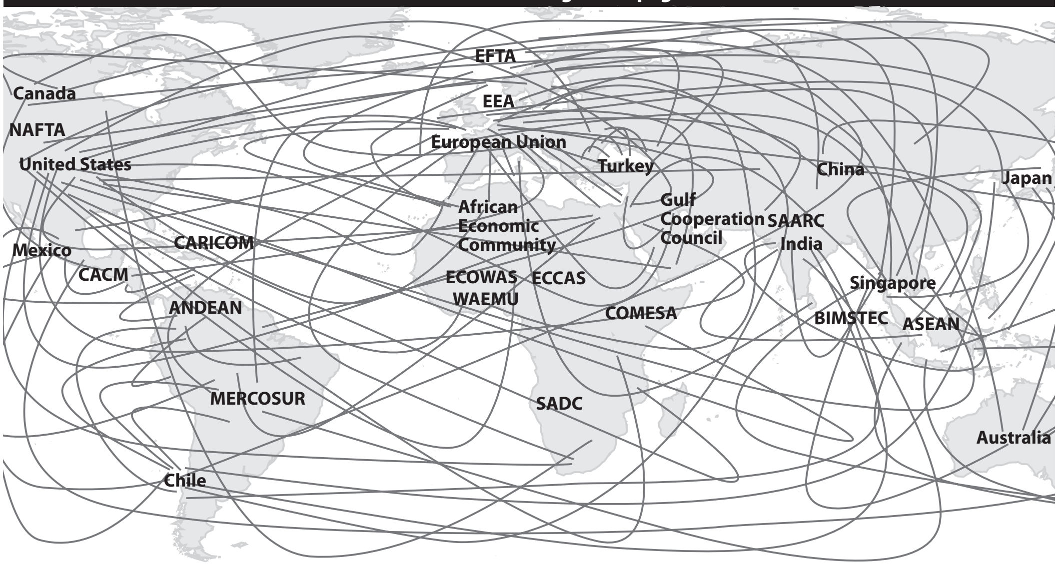
What follows is a discussion of the most relevant types of IIAs at the bilateral, regional and multilateral levels and other international instruments that deal with FDI.

[23] For present purposes, the latter is defined as any organization created by statute within a State that is given control over an economic activity.

[24] See UNCTAD (2004b).

Figure 22

IIAs between countries and regions "spaghetti bowl"



Source: Based on World Bank (2005).
Note: EFTA European Free Trade Association; EEA European Economic Area; ECCAS Economic Community of Central African States; WAEMU West African Economic and Monetary Union; SADC Southern African Development Community; SAARC South Asian Association for Regional Cooperation; BIMSTEC Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation.

1.2 Bilateral investment treaties

Since the late 1950s, bilateral treaties for the promotion and protection of investment have become the most widely used type of treaty in the field of foreign investment, their total number has reached approximately 2,676 at the end of 2008 (UNCTAD, 2009). Such treaties have replaced an earlier type of bilateral treaty, the treaty of friendship, commerce and navigation, which included provisions on rights of foreign nationals and companies among rules on a broad range of aspects of bilateral economic and political cooperation. By contrast, the distinguishing feature of the modern BIT is that it deals exclusively with issues concerning the admission, treatment and protection of foreign investment (box 28).

Box 28

Common features of BITs

BITs exhibit a certain pattern of uniformity in their structure and content. Elements common to virtually all such treaties are the use of a broad definition of the term "investment", the inclusion of certain general standards of treatment of foreign investment, such as fair and equitable treatment and full protection and security, and more specific standards of protection regarding expropriation and compensation, transfer of funds, and the protection of foreign investment in case of civil strife. Most such treaties also provide for national and most-favoured-nation (MFN) treatment, although this is frequently limited to the treatment of foreign investment after admission. Many such treaties provide for the ability of States as well as foreign investors to resort to international arbitration.

Source: UNCTAD (2004b).

A large number of BITs are between a developed country, on the one hand, and a developing country or economy in transition on the other (so-called "North-South" BITs). In 2008 developing countries were involved in 46 of 59 agreements concluded. Also important is that the proportion of BITs concluded between developing countries is increasing. In 2008, 13 agreements were concluded between developing countries supporting the trend of increased South-South cooperation.

BITs have rarely been concluded between developed countries, although developed countries are top sources as well as top recipients of FDI flows (see Module 1, theme 2). From the point of view of a home developed country, this may suggest that BITs are less related to the specific size of FDI outflows to a particular economy. BITs rather relate to the general need of investment protection as an element complementing a host country's domestic regulatory framework.

There is evidence that a favourable international investment framework can contribute to attracting FDI. While some studies do not reveal a significant impact of BITs in determining FDI flows to host countries, others concur that IIAs can have a certain influence on a company's decision where to invest. For example, IIA could have signaling effect, supposing that a host country's attitude towards FDI has changed and its investment climate is improving. As BITs are a part of one country's general investment climate, they are among several factors that impact on a company's investment decision. This means that IIAs should be embedded in a general policy framework to attract FDI (UNCTAD, 2009).

1.3 Double taxation treaties

International double taxation occurs when two different States impose the same type of tax on the same taxpayer and on the same taxable item (e.g. income). Double taxation can discourage trade and investment when income such as business profits and investment returns is taxed twice. Bilateral tax treaties, known as DTTs are the primary means of avoiding double taxation and eliminating such tax barriers. In so doing, they are indirectly promoting trade and investment.

DTTs concluded between two countries aim to eliminate the double taxation of income or gains arising in one country and paid by residents of the other country. The number of DTTs worldwide at the end of 2008 was over 2,800 (UNCTAD, 2009).

Although DTTs focus on taxation and not on investment, they are included among investment-related international agreements because of their important role in facilitating investment flows. However, BITs and the investment chapters in regional and multilateral agreements remain the main agreements with respect to regulating international investment.

1.4 IIAs other than BITs and DTTs[25]

There is a significant number of IIAs, other than BITs and DTTs. These "other IIAs" can have a variety of names such as Regional Trade Agreement (RTA), Economic Partnership Agreement (EPA), new-age partnership agreement, economic complementation agreement, agreement for establishing a FTA or closer economic partnership arrangement. Typically, these "other IIAs" encompass a range of issues beyond investment. From an investment perspective, they can be divided into three different types:[26]

- Agreements (bilateral, plurilateral or regional) with investment chapters that contain **obligations commonly found in BITs;**
- Agreements with **limited investment-related provisions** confined for example to investment (i.e. commercial presence) in **services** or the **right of establishment;**
- Agreements that express a **commitment to promote investments** and/or establish an **institutional framework** to monitor, cooperate or **negotiate** on investment or investment-related issues.

[25] Additional useful information on this can be found in the Vi teaching material on Regional Trade Agreements, available at: *http://vi.unctad.org*.

[26] Note that overlaps may exist between these categories, with one IIA exhibiting several of the three identified features.

Frequently, the above types of investment provisions are found in agreements that aim at the economic integration of a limited number of States, usually from the same region. These agreements belong to a category that is generally referred to as EIAs. EIAs seek to facilitate international trade in goods and services and cross-border movements of other factors of production.

The degree of economic integration sought by member countries of EIAs varies, depending on the specific type of integration agreement. More advanced types of economic integration agreements include the following:

- **A preferential trade arrangement** reduces tariffs and non-tariff barriers on trade in goods and services among member countries. While the tariffs are not necessarily eliminated, they are lower than countries not party to the agreement.
- **A free trade area/agreement** eliminates tariffs and non-tariff barriers, notably quotas, on trade in goods and services between member countries. Unlike a customs union, each member country in an FTA retains its own tariffs and quotas on trade with third countries.
- **A customs union** (CU) removes, as an FTA does, restrictions on mutual trade. Moreover, it also adopts a common system of external tariffs and quotas with respect to trade with third countries. In other words, it is a free trade zone with a common external tariff.
- **A common market**, in addition to being a customs union, involves the freedom of movement of production factors: capital and labour. Harmonization of policies or common policies among member countries *vis-à-vis* third countries are possible.
- An **economic and monetary union** is a common market with a common currency and common economic policies. It implies a high degree of coordination or even unification of the most important areas of economic policy, as well as common institutions with supranational powers.
- **Complete economic integration** is the final stage of economic integration. All economic policy areas are harmonized or replaced by common policies, and a supranational State develops, making decisions on behalf of member governments.

EIAs can be:

- (Intra-)**regional agreements:** In fact, most of EIAs are between countries from the same region, and EIAs with various degrees of economic integration exist in almost all regions; or
- **Interregional agreements:** Some EIAs are between two or more countries or organizations of countries from different regions of the world.

In more advanced phases of economic integration, some agreements provide for the creation of regional institutions, with specific competences. Organizations of sovereign States which are committed to economic integration, and to which the member States have transferred competence in certain matters, are called regional economic integration organizations. In the name of their member countries, these regional institutions can conclude agreements with third countries.[27]

Other examples of regional and interregional EIAs[28] include the NAFTA, the ASEAN, the MERCOSUR, the Gulf Cooperation Council (GCC), the EU or the COMESA (see annex).

1.5 Multilateral agreements

The most important multilateral effort to create international rules for investment was undertaken in the early years after World War II (the late 1940s) within the framework of the **Havana Charter**. However, the attempt to conclude the Havana Charter failed and was followed by other – likewise unsuccessful – efforts to create comprehensive multilateral rules for FDI. These efforts include the United Nations Code of Conduct on Transnational Corporations, in the late 1970s and 1980s, the Multilateral Agreement on Investment by the **OECD**, in the late 1990s (box 30) and the Doha round of WTO negotiations in 2003 (box 31).

However, recent years have also seen the adoption of multilateral agreements – or instruments that deal with investment aspects. Examples for non-binding instruments include:

- The **non-binding World Bank Guidelines on the Treatment of FDI** were adopted in 1992. In this instance, a certain degree of international consensus existed on standards of treatment of investors, which are set up by the guidelines.[29]

- The **ILO Tripartite Declaration** of Principles Concerning Multinational Enterprises and Social Policy deals with a range of labour-related issues.

- The **OECD Guidelines for Multinational Enterprises** and the **OECD Guidelines for Recipient County Investment Policies Relating to National Security** (box 29).[30]

[27] See for example the IIA between ASEAN and the Republic of Korea (2009) or the FTA between the Gulf Cooperation Council and New Zealand (2009).

[28] For a detailed analysis see UNCTAD (2006a).

[29] See World Bank (1992).

[30] The OECD Guidelines are recommendations on a voluntary basis. For the OECD Guidelines for Recipient Country Investment Policies Relating to National Security, see *http://www.oecd.org/dataoecd/11/35/43384486.pdf*. The Guidelines for Multinational Enterprises are available at: *http://www.oecd.org/dataoecd/56/36/1922428.pdf*. In 2009 the OECD embarked on an update of its Guidelines for Multinational Enterprises, available at: *http://www.oecd.org/dataoecd/32/62/44168690.pdf*.

Box 29

OECD and international investment instruments

While the OECD itself is an international organization of 30 of the most high-income countries, its work related to international investment has a far greater reach encompassing many developing countries. To navigate through the investment instruments developed by the OECD since 1976 a basic distinction must be made. One the one hand, the OECD authors non-binding guidelines for multinational enterprises and governments. On the other hand, the OECD Council issues decisions related to the treatment of investments that are legally binding on its member States.

The most important non-binding instruments of the OECD are its Guidelines for Multinational Enterprises. These rules address economic activities of enterprises worldwide on a wide range of issues including human rights, employment, environment, information disclosure, combating bribery, consumer interests, competition and taxation. With all 30 OECD member countries and 12 non-member countries as signatories, the Guidelines cover 85% of global foreign direct investment. Yet the significance of these OECD rules goes even further, since they frequently serve as reference points in investor-State contracts. Since their first formulation in 1976 the OECD Guidelines for Multinational Enterprises have undergone continuous revision. For 2010, the OECD has announced another review of the rules in order to bring them up to date with contemporary investment practice.

Aside from rules on multinational enterprises, the OECD also makes recommendations for investment-receiving governments. In 2009, for instance, the OECD issued Guidelines for Recipient Country Investment Policy relating to National Security in response to a proliferation of national regulations that submit new investment to a security review. These guidelines were drafted to assist countries to strike a balance between national security interests and fair and predictable investment conditions.

In addition to its non-binding guidelines, the OECD Council issues decisions binding on its member States to improve the climate for investments, to ensure a positive impact on host State development and to facilitate the international co-ordination of investment policies. Among these are decisions on National Treatment, on the establishment of National Contact Points to assist the implementation of the Guidelines, and on the Code of Liberalisation of Capital Movements.

Source: OECD Guidelines for Multinational Enterprises, Guidelines for Recipient Country Investment Policies Relating to National Security, Code of Liberalisation of Capital Movements, Code of Liberalisation of Current Invisible Operations, Declaration and Decisions on International Investment and Multinational Enterprises (*http://www.oecd.org*).

Among the multilateral agreements dealing with specific aspects of investment are:

- The **Convention on the Settlement of Investment Disputes** between States and the nationals of other States (signed in Washington, in 1965) provides a framework for the settlement of investment disputes and creates the ICSID based in Washington, DC.
- The **Convention Establishing the Multilateral Investment Guarantee Agency**, signed in 1985 in Seoul, enhances the legal security of FDI by supplementing national and regional investment guarantee schemes with a multilateral one.
- The **Energy Charter Treaty**, a multilateral agreement in the sector of energy, contains provisions on energy sector investment between the 50 plus signatory countries.

Box 30

The Multilateral Agreement on Investment

Efforts to negotiate the creation of international investment rules were carried out by OECD members within the context of the Multilateral Agreement on Investment, until the discontinuation of discussions in December 1998 (OECD, 1998; UNCTAD, 1998). At the OECD Council meeting on 28 April 1998 it became clear that the MAI negotiations were encountering significant difficulties. France, for example, announced that it would no longer send its delegation to participate in the negotiations.

The MAI negotiations set out to provide high standards for the liberalization of investment regimes and investment protection between OECD member countries and, eventually, other interested non-member States. While the negotiations resulted in a convergence of views on a number of substantive areas, too many unresolved issues remained to conclude the negotiations successfully. These related to the definition of investment, exceptions to national and most-favoured-nation treatment, intellectual property, cultural exception, performance requirements, labour and environmental issues, regulatory takings, and settlement of disputes.

Box 30

The Multilateral Agreement on Investment

In addition other factors that contributed to the failure of the MAI negotiations were, first, the opposition of non-governmental organizations to the underlying philosophy, objectives and some of the substantive provisions under discussion, as well as the process of negotiations, which in their view was too closed and opaque; second, the initial strong support of the business community for the MAI negotiations waned after it became clear that no significant liberalization was in sight, and that the issue of taxation would be excluded from the rules; and third, the aftermath of the election of centre/left governments in a number of OECD countries ushered in new political priorities which, given that no compelling problems of investment protection existed in the OECD area, left little incentive for political leaders to push the negotiations forward. Thus, the opposition of NGOs, the limited interest of the business community, and the negative outcome of an overall political cost-benefit analysis combined with the complex substantive issues sealed the fate of the MAI negotiations.

Source: UNCTAD (1999a).

Box 31

Trade and investment at the WTO

The first WTO Ministerial Conference in Singapore in 1996 established the Working Group on the Relationship between Trade and Investment, along with three other working groups dealing with the so-called "Singapore issues".

At the Fourth WTO Ministerial Conference in Doha in November 2001, members of the WTO recognized "the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment that will contribute to the expansion of trade". It was also agreed "that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that session on modalities of negotiations".

After the Doha Conference, the Working Group focused on clarifying the seven issues mentioned in the Declaration: scope and definition; transparency; non-discrimination; modalities for pre-establishment commitments based on a GATS-type, positive list approach; development provisions; exceptions and balance-of-payments safeguards; consultation and the settlement of disputes between members. Its work was also guided by a number of principles spelled out in the Doha declaration such as the need to balance the interests of countries where foreign investment originates and where it is invested, countries' right to regulate investment, development, public interest and individual countries' specific circumstances. Support and technical cooperation for developing and least developed countries, and coordination with other international organizations such as UNCTAD were also emphasized.

During the Ministerial Conference in September 2003 in Cancún, ministers were supposed to decide whether there is an "explicit consensus" on modalities that would allow negotiations to go ahead, leading to new WTO rules on trade and investment. However, the discussions collapsed in Cancún and, in July 2004, the General Council decided to discontinue the negotiations on the relationship between trade and investment.

The main concern expressed by some developing countries was that a multilateral agreement would add obligations on them, while limiting their ability to align investment inflows with national development objectives.

Source: UNCTAD (2003: 93); WTO (2003).

Even though the efforts to create a multilateral investment framework have failed, the WTO legal framework still contains a number of multilateral agreements that address investment through related issues (see also Module 3 for detailed examples). The most notable ones are:

- **The WTO General Agreement on Trade in Services**, concluded as part of the Uruguay Round, offers a comprehensive set of rules covering all types of international services delivery, including "commercial presence". The commercial presence of the service providers involves FDI. The GATS leaves member countries considerable flexibility on the scope and speed of liberalizing services activities. It allows them to inscribe, within their schedules of commitments, activities that they wish to open and the conditions and limitations for doing this – the positive list approach.

- **The WTO Agreement on Trade-Related Investment Measures** (also adopted as part of the Uruguay Round) prohibits certain national investment measures that could distort trade flows.

The long series of failed attempts to establish a multilateral framework for foreign investment demonstrates the challenges which efforts of this kind might also face in the future. Nonetheless there are options – below the threshold of legally binding rules – to further multilateral consensus and cooperation on investment-related issues. In the absence of a multilateral approach to international investment rule-making, multilateral consensus building and cooperation can contribute to making today's investment regime function in a way that is more efficient and conducive to growth and development. In general multilateral consensus building can help developing a common understanding of key issues in IIAs and identify areas of consensus and disagreement and thereby increase the clarity and coherence of international investment rule-making.[31]

[31] See UNCTAD (2009c).

2 Evolution of and recent trends in IIAs

The past two decades have seen significant changes in national and international FDI policies (box 32), related to the novel role of FDI in an increasingly integrated world economy (for the changes at the national level, see Module 2, theme 1). At the international level, these changes have found their expression in a variety of instruments, bilateral, regional and plurilateral instruments.

Box 32

FDI rules: a historical view

While in earlier times indirect foreign investment was far more important than direct, FDI acquired increasing importance as the twentieth century advanced, and it began gradually to assume the forms prevalent today. However, for quite some time FDI remained a matter of national concern, moving into the international arena, where rules and principles of customary law applied, only in exceptional cases, when arbitrary government measures affected it.

After the end of World War II, attitudes towards FDI were shaped by the prevalence of political support for State control over the economy and the beginnings of decolonization. For a long time socialist countries excluded FDI from their territories, while developing countries endeavored to regain control of their natural resources from foreign interests. At the same time, controls and restrictions over the entry and operation of foreign firms were imposed in many countries, and no international consensus on the pertinent legal norms could be reached.

In the 1980s, a series of national and international developments within the context of the globalization process, mainly related to increased concern in attracting FDI and creating stable conditions for it, radically reversed prevailing policy trends, which had a significant impact on the regional and worldwide efforts to establish international rules on the subject. By the end of the 1990s, host countries were seeking to attract FDI, by dismantling restrictions on its entry and operations and by offering strict guarantees against measures seriously damaging foreign investors. An international legal framework for FDI began to emerge. It is based on customary international law as well as on national laws and regulations, and it is composed of a multitude of international investment agreements and other legal instruments.

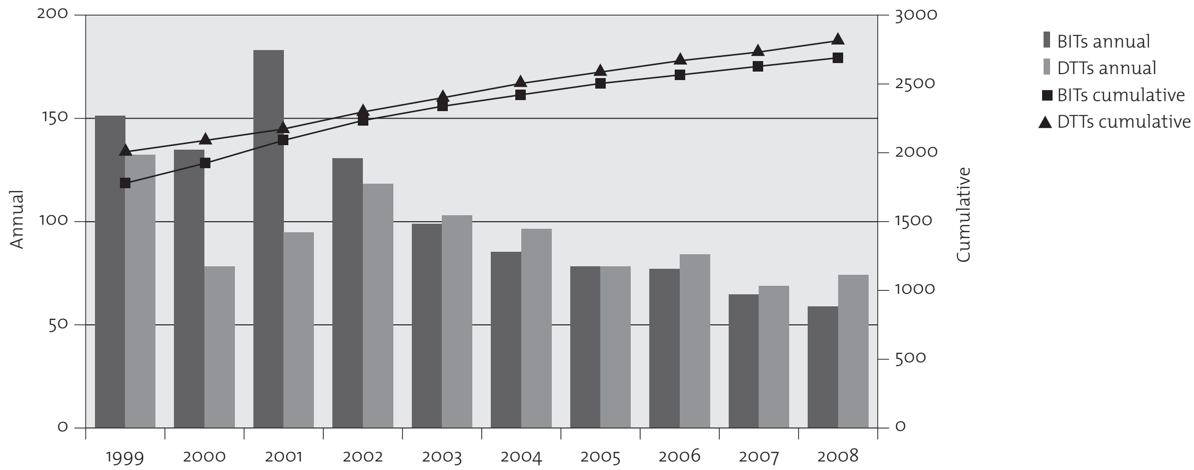
Source: UNCTAD (1999b).

2.1 Trends and developments in BITs

The number of BITs worldwide has increased rapidly with most of them completed during the 1990s. From 388 in 1990, their number has grown continuously to a total of 2,676 at the end of 2008 (figure 23). There has been a slowdown in the conclusion of BITs between 2001 and 2004, however, since then, the average increase has been stable (approximately 75 BITs per annum) for the last four years. In 2008, 59 new BITs were signed. Among developing countries, Asian countries led, with 31 new BITs in 2008.

Figure 23

Cumulative number of BITs and DTTs, 1999-2008



Source: UNCTAD (2009d).

BITs traditionally cover the following key issues:

- Scope and definition of investment;
- Admission and establishment;
- National treatment;
- Most-favoured-nation treatment;
- Fair and equitable treatment;
- Compensation in the event of expropriation or damage to the investment;
- Guarantees of free transfers of funds;
- Investor-State dispute settlement.

Most recently, a new generation of BITs, showing an increasing variety of content in the number of substantive issues covered and the manner in which individual provisions are drafted, is gradually emerging. This new generation of BITs follows the trend set by some of the other recent IIAs, which increasingly include investment chapters.

Among other changes, the new generation of BITs addresses a broader set of issues and places a stronger emphasis on issues relating to public policy concerns associated with foreign investment. With the latter, countries seek to ensure more room for host country regulation. Through exception clauses, covering national security and public order, the protection of health, safety, the environment, and the promotion of core labour rights and cultural diversity, the new generation of BITs aims at clarifying that investment protection and liberalization objectives of investment agreements cannot be pursued at the expense of these key public policy objectives (see box 33). Issues related to the "Right to Regulate", flexibility for development, policy space and corporate social responsibility are of paramount importance in this context.

Box 33

Exceptions for public policy measures

Countries' IIAs increasingly include exceptions aimed to safeguard public policy objectives (e.g., the protection of public health, safety, or the environment). In so doing, countries use different formulations and approaches. Several exceptions are modeled on provisions on general exceptions as they are included in the WTO Agreements (e.g. General Agreement on Tariffs and Trade, GATT, Art. XX)). They refer to the protection of "human, animal, plant life or health" and to the "preservation of natural resources" and make the application of public policy measures subject to certain qualifications (e.g. avoidance of arbitrary and unjustifiable discrimination, no disguised restriction on international trade). Some IIAs go further by specifying in their expropriation provisions that regulatory actions by a State, designed to protect legitimate public welfare objectives, do not constitute indirect expropriation. Finally, some exceptions are qualified by the requirement that environmental measures can only be taken under the condition that they are "otherwise consistent with the provisions of the agreement".

The Canada-Jordan Foreign Investment Protection and Promotion Agreement states in Article 10, General Exceptions: "Subject to the requirement that such measures are not applied in a manner that would constitute arbitrary or unjustifiable discrimination between investments or between investors, or a disguised restriction on international trade or investment, nothing in this Agreement shall be construed to prevent a Party

Box 33

Exceptions for public policy measures

from adopting or enforcing measures necessary: (a) to protect human, animal or plant life or health; (b) to ensure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement; or (c) for the conservation of living or non-living exhaustible natural resources."

The Australia-Chile FTA (2008) specifies that: "Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations."

The US-Rwanda BIT (2009) for example, provides in Article 12, Investment and Environment: "Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining, or enforcing any measure otherwise consistent with this Treaty that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns."

Source: UNCTAD (2008b).

Another trend is that countries are increasingly embarking on is the renegotiation of their existing treaties. They do so, when these treaties reach their expiration date or when countries seek to respond to changed economic and/or political circumstances. Several members of the EU, for example, are renegotiating the BITs they had concluded before their EU membership. While BITs generally provide for tacit renewal after their expiration, in some cases countries also re-negotiate with an aim to establish more precise rules and definitions and to avoid potential disputes.

2.2 Trends in DTTs

The network of DTTs is also expanding (figure 23). In 2008, for instance, 75 new DTTs were concluded. This represents a sustained growth of DTTs albeit at a slightly slower pace since the year 2003. The total number of DTTs reached 2,805 by the end of 2008 (UNCTAD, 2009).

2.3 Evolution of IIAs other than BITs and DTTs

As mentioned earlier, in addition to BITs and DTTs, international investment rules are increasingly being adopted as part of bilateral, regional, interregional and plurilateral agreements that address, and seek to facilitate, trade and investment transactions. These other IIAs take the form of bilateral free trade agreements or regional economic integration agreements.

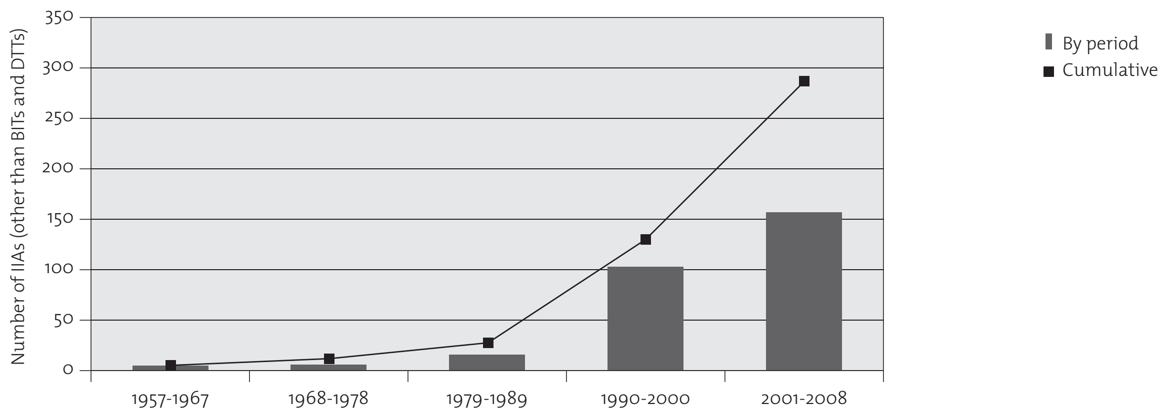
The number of such agreements has been growing steadily (figure 24) and reached 273 by the end of 2009, with 17 new agreements concluded during 2008. The large majority of the agreements, about 87 per cent, were concluded since the 1990s (figure 24). Until the late 1980s, investment facilitation through these agreements remained confined mainly to intraregional processes involving countries at similar levels of development, albeit with a few exceptions (such as the agreements between the European Community and developing countries). Since 1990, however, countries and groups located in different regions began to conclude trade and investment agreements with one another, involving both developed and developing countries. Most recently, there has been – again – a significant increase in agreements among developing countries.

The proliferation of these types of agreements is one of the key developments in international economic relations in recent years. These “other IIAs” are particularly relevant as they manifest a trend towards a more integrated approach when dealing with interrelated issues in international investment rule-making.

Compared to BITs, these other IIAs show far more variation in their scope, approach and content. However, as they encompass more and more issues (including trade in goods and services, investment and capital flows, as well as movement of labour), their complexity increases and so does the likelihood of overlaps and inconsistencies between provisions. At the same time, the greater variation they contain presents an opportunity for experimenting with different approaches and accounting for special circumstances of countries at different levels of economic development.

Figure 24

Growth of IIAs other than BITs and DTTs, 1957-2008



Source: UNCTAD (2009d).

2.4 South-South cooperation[32]

Developing countries have intensified their efforts to conclude IIAs among themselves. Indeed, agreements on investment between developing countries have increased substantially in both number and geographical coverage over the past decade, according to UNCTAD data (figure 25).

Out of the 64 new BITs signed during the year 2008, 15 were among developing countries (so-called "South-South" BITs). Also the total number of BITs points to the emerging importance of South–South cooperation on investment issues: as of end 2008, South–South BITs accounted for 27 per cent (722) of all BITs. China alone accounted for a large share of these South–South agreements: about 60 per cent of the Chinese BITs concluded from 2003 to end 2009 were with other developing countries, mainly in Africa.

Also IIAs other than BITs and DTTs that were concluded between developing countries experienced a significant increase since the 1990s. 59 such agreements between developing countries were signed since 1990. This suggests that developing countries are increasingly pursuing development strategies based on cooperation among themselves on trade and investment.

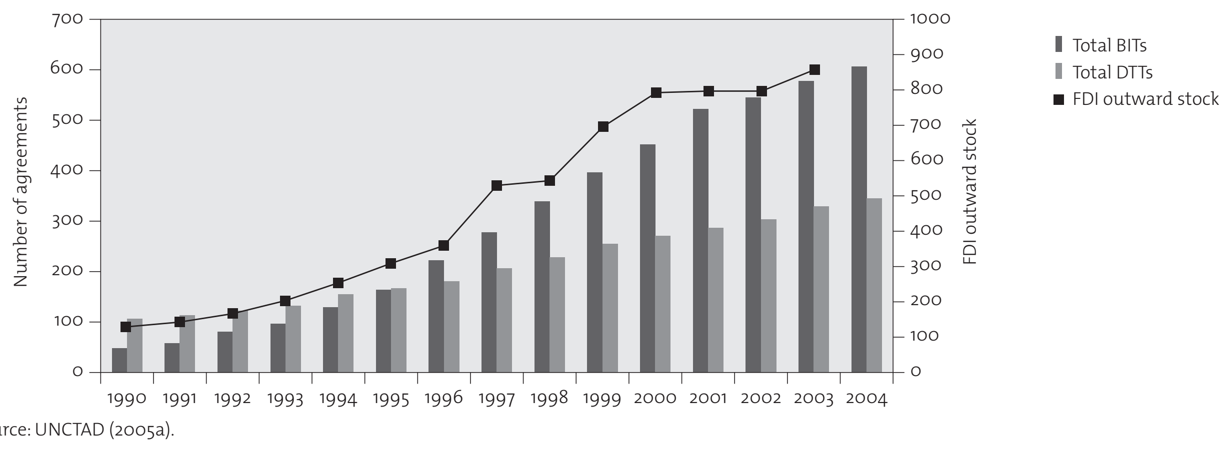
Concurrently, the role of developing countries in international investment rulemaking continues to grow in general. By June 2008, developing countries were parties to 76 per cent of all BITs, 61 per cent of all DTTs and 81 per cent of all other IIAs. In fact, three developing countries are among the "top" signatories of BITs worldwide: China, Egypt and the Republic of Korea.

The growing role of developing countries in IIA treaty-making also reflects that these countries are increasingly home countries of FDI flows and that their companies start to figure more prominently among the world's major. Moreover, FDI flows originating from developing countries have grown faster than those from developed countries since the late 1990s. Hence, the past decade has seen a major shift in investment patterns, with developing and transition economies now accounting for nearly one half of global FDI inflows and one fifth of global outflows. Accordingly, some developing countries – such as Brazil, China, Republic of Korea, India, Mexico – have become important investors abroad.

[32] See also UNCTAD (2005b).

Figure 25

South-South cooperation: BITs and DTTs, 1990-2004



Source: UNCTAD (2005a).

2.5 Conclusion

Recent primary trends in IIAs include the following:

- International agreements that directly or indirectly concern foreign investment are complex and dynamic in terms of form and substance, creating a multifaceted and mulitlayered group of IIAs.
- The number of BITs and bilateral DTTs continued to rise.
- International investment rules are increasingly being formulated as part of agreements that encompass a broader range of issues (including, notably, trade in goods and services, intellectual property rights, or the movement of other factors of production).
- Investment provisions in the new agreements tend to be more sophisticated and complex in content, clarifying in greater detail the meaning of certain standard clauses.
- Among the new BITs some are newly renegotiated treaties that replace earlier BITs between the same partners.
- Developing countries play an increasingly important role in IIA rule-making, and cooperation among developing countries on international investment policy is intensifying.
- International investment rule-making is increasingly taking place in a new environment, with novel challenges at the global and domestic levels (e.g. challenges related to the global financial and economic crisis as well as environmental challenges, including climate change).

A large number of IIAs are currently under negotiation and/or re-negotiation, suggesting an increase in the coming years. Hence, the international framework of investment rules continues to expand at the bilateral, subregional, regional and interregional levels. This also increases the risk that the present system of investment agreements will become even more complex in the future, raising the likelihood of conflicting rules and investment disputes, as well as costs of compliance for both governments and businesses of the parties to the agreements. Therefore, coherence is not only required between different IIAs but also between IIAs and investment policies on one hand, and other international agreements and policies (e.g. environmental or climate change related policies) on the other hand (see section 6 of this module).

3 International investment disputes

IIAs typically contain provisions on dispute settlement, which set out the judicial mechanisms for settling disputes that arise between States (State-State) or between a foreign investor and a host State (investor-State). Over the recent years, the expanding IIA regime has been accompanied by continuing proliferation of ISDS cases, raising considerable challenges for host countries (figure 26).

Most BITs and IIAs provide that any dispute between States concerning the interpretation or application of a treaty which is not resolved through negotiations or consultations between the parties shall at the request of either party be submitted to an arbitral tribunal. Moreover, virtually all modern BITs – and other IIAs to the extent that they contain protection rules – also include specific mechanisms for the settlement of disputes between foreign investors and host countries.

Such mechanisms were originally envisaged in response to the fact that the complex operations of modern enterprises can give rise to a host of legal problems, leading to disputes with their host countries. While such disputes are normally subject to the jurisdiction of the host State's courts, investors, and their States of nationality, have insisted on additional means of dispute settlement, aiming to better protect investment. Among the consideration in supporting this approach was a certain mistrust towards foreign investment that used to be prevalent in certain host countries; the high political importance of some disputes, which had given rise to fears that neutral national decision makers would be hard to find; a perceived lack of judicial expertise in some developing countries' courts; and a desire for speedier resolution of possible conflicts. As a response to these concerns, BITs today typically offer the possibility for investors to submit foreign investment disputes to international arbitration.

Generally, IIAs offer different options for the rules and venues under which ISDS arbitration can take place. Typical examples include: the arbitration rules of the Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID Convention); the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL); the Rules of Arbitration of the International Chamber of Commerce (ICC), administered by the International Court of Arbitration of the ICC; and the Arbitration Rules of the Arbitration Institute of the Stockholm Chamber of Commerce. A key feature of modern IIAs is that the choice between the various possible venues for arbitration is usually left to the foreign investor.

Usually IIAs require prior recourse to consultations and negotiation as a precondition for invoking international arbitration. Sometimes, IIAs stipulate a minimum period of time before the dispute can be submitted to international arbitration. Most IIAs are silent on the nature of the remedies that may be awarded by tribunals in the context of ISDS proceedings. However, some agreements provide that the remedies available are limited to monetary damages, which may include applicable interest; restitution of property; and the costs of the arbitration proceedings. Thus arbitral tribunals are typically precluded from ordering or recommending that States modify or revoke a measure that is subject to arbitration.

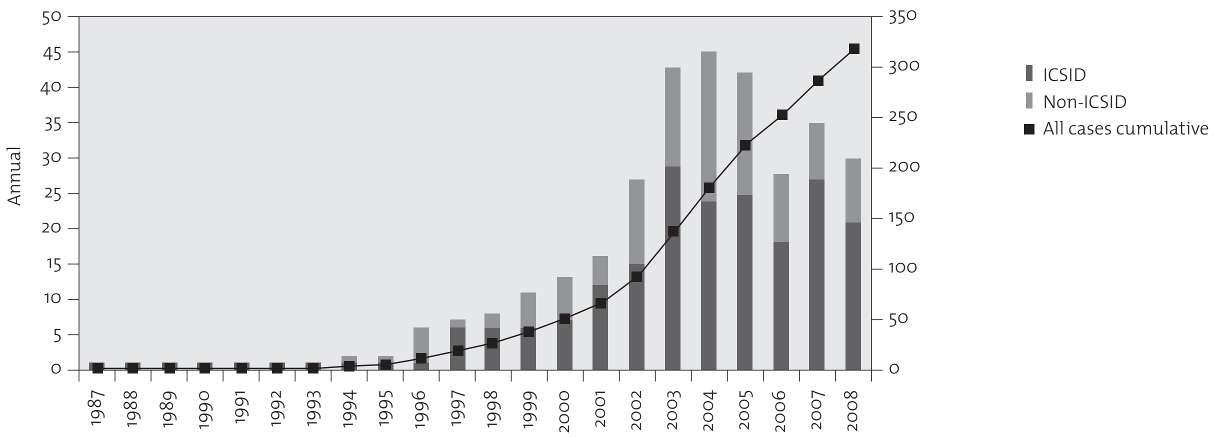
Although ISDS clauses have been included in IIAs since the 1960s, the use of these provisions to institute arbitral proceedings has been rare until recently. Until April 1998, only 14 cases involving a BIT had been brought to the ICSID and only two awards and two settlements had been issued. However, since the end of 1990s, the number of cases has grown dramatically: in 2008, at least 30 new investor-State cases were filed under IIAs, 27 of which were filed with ICSID.[33] By the end of 2008, the cumulative number of known treaty-based cases reached 317 (figure 26).

By end of 2008, at least 77 governments had faced investment treaty arbitration: 47 developing countries, 17 developed countries and 13 countries with economies in transition. Most claims were initiated by investors from developed countries. Of the 96 concluded cases at the end of 2008, approximately half were decided in favour of the State (51) and half in favour of the investor (45). Overall, Argentina still tops the list with 48 claims lodged against it. Mexico has the second highest number of known claims (18). The Czech Republic follows with 15 cases and Ecuador with 14 cases (four new cases filed in 2008). Canada and the US have 13 and 12 cases, respectively.

[33] This number does not include cases that are exclusively based on investment contracts (State contracts) and cases where a party has so far only signalled its intention to submit a claim to arbitration, but has not yet commenced the arbitration (notice of intent); if these latter cases are submitted to arbitration, the number of pending cases will increase.

Figure 26

Known investment treaty arbitrations, 1987-2008



Source: UNCTAD (2009d).

Of the total 317 known disputes, 201 were filed with ICSID (or the ICSID Additional Facility), 83 under UNCITRAL, 17 with the Stockholm Chamber of Commerce, five with the International Chamber of Commerce and five were ad hoc. One further case was filed with the Cairo Regional Centre for International Commercial Arbitration and one was administered by the Permanent Court of Arbitration (PCA). In four cases, the applicable rules are unknown so far.

Under several arbitration systems, the existence of a dispute and its final decisions are never made public. Even under the ICSID arbitration system – the only forum that maintains a public registry of claims – not all decisions of the tribunals have been made public. This situation is gradually changing with the new ICSID rules applicable from 10th April 2006. Rule 48, for example, requires the tribunal to make the legal reasoning of the award publicly available.

The continuing proliferation of ISDS cases is raising considerable challenges for host countries. This particularly concerns developing countries, as they face additional cost and capacity related challenges as well as damages to their country's reputation as an attractive FDI destination. As a result, international arbitration has the potential to negatively affect the country's investment climate and decrease public support for foreign investment.

ISDS cases cover a broad range of investment activities. They relate to all kinds of investments, including privatization contracts and State concessions. They apply to a diversity of industries and activities, including construction, water and sewage services, brewing, telecommunications concessions, banking and financial services, hotel management, television and radio broadcasting, hazardous waste management, textile production, gas and oil production, and various forms of mining.

Moreover, the increasing number of disputes has raised fundamental questions regarding IIAs' potential to constrain governments' autonomy in pursuing legitimate public policy objectives. There are concerns that IIAs and their potential for ISDS cases may narrow national policy space (see box 34 for additional information).

Box 34

Investor-State disputes relating to public policy measures

Recently, three cases attracted broad attention due to their public policy implications (equality and human rights, environment and health).

Foresti versus South Africa (initiated in 2007): ISDS used to challenge equality policies
The ICSID case Foresti versus South Africa arises out of a dispute related to the alleged expropriation of mineral rights. At issue was the new Mineral Act that related to South Africa's Black Economic Empowerment (BEE) policies which address equal opportunities and equitable access to land and resources for the black population. The act requires white-owned mining companies to sell a certain percentage of their equity to "historically disadvantaged South Africans". Claiming that the measure is discriminatory against foreign investors, a group of European investors in the mining sector alleges that South Africa had breached its BITs with Italy (1997) and Belgium-Luxembourg (1998). The investors filed a dispute before ICSID seeking compensation for alleged expropriation amounting to approx. 266 million EUR. The case requires the tribunal to determine whether the BEE measures taken by South Africa's government are in breach of BIT obligations or should rather be seen as a legitimate exercise of the government's policy power. The case can therefore be seen as a test case for South Africa's post-apartheid legislation and may impact on other investors' considerations before filing a dispute against the government.

Vattenfall versus Germany (initiated in 2009): ISDS used to challenge implementation of environmental laws
The ICSID case Vattenfall versus Germany relates to environmental restrictions imposed on a coal-fired power plant that Vattenfall, a Swedish State-owned company, is constructing in the area of Hamburg. Vattenfall argues that it has suffered damages due to environmental restrictions relating to the use of river water and delays in issuing permits. Claiming that Germany has breached the Energy Charter Treaty, the investor is seeking compensation of damages amounting to more than 1.4 billion EUR. As the environmental measures on river water taken by Germany were implemented in response to the EU Water Framework Directive and German domestic law, the case raises general questions about the relationship between domestic and EU environmental regulations and countries' obligations under IIAs. The case also illustrates that changes in environmental laws or their implementation may bring about disadvantages for an investor and can potentially be considered as violations of treaty obligations, giving rise to ISDS claims. The dispute may therefore impact on the future adoption and implementation of environmental laws, domestically and at the international level.

Philip Morris versus Uruguay (initiated in 2010): ISDS used to challenge public health policies
Philip Morris International filed a request for international arbitration with ICSID accusing Uruguay of a violation of the BIT with Switzerland (1988). The dispute relates to Uruguay's tobacco packaging regulations (including health warnings, marketing restrictions and labeling requirements for cigarettes) which were enacted in response to public health concerns about the use of tobacco. More specifically, the measures were taken in accordance with the WHO Framework Convention on Tobacco Control that came into force in 2005. The claim, therefore, raises questions concerning the relationship between government's legitimate regulatory powers as well as governments' multiple obligations under different international agreements.

Source: Piero Foresti, Laura De Carli and others versus Republic of South Africa (ICSID Case No. ARB (AF)/07/1); Vattenfall Europe AG, Vattenfall Europe Generation AG versus Federal Republic of Germany (ICSID Case No. ARB/09/6); FTR Holding S.A. (Switzerland), Philip Morris Products S.A. (Switzerland) and Abal Hermanos S.A. (Uruguay) versus Oriental Republic of Uruguay (ICSID Case No. ARB/10/7).
Note: WHO World Health Organization

In addition to broader public policy issues, the financial implications of ISDS cases also can be substantial, both from the point of view of the costs of the arbitration proceedings and of the awards rendered (box 35).

All of this suggests that countries put increasing attention on avoiding disputes. Better treaty language, a more considerate approach to signing IIAs, as well as domestic policies to strengthen dispute avoidance and instead use alternative mechanisms for dispute resolution can offer initial responses in this context. Alternative approaches to international investment arbitration might encourage a general shift to less adversarial means of implementing existing agreements in the future. In this context, UNCTAD has also expanded its research and policy analysis to alternative methods of dispute resolution (ADR) and Dispute Prevention Policies (DPPs)[34] and is also offering technical assistance to countries who are putting in place domestic mechanisms for ADR or DPP.

[34] See for example, UNCTAD (2010a), as well as W&L-UNCTAD Joint Symposium on "International Investment and ADR: Preventing and Managing Investment Treaty Conflict", held on 29 March 2010, in Lexington, Virginia, USA, available at: *http://investmentadr.wlu.edu/*.

Box 35

Financial implications of international dispute settlement cases

Although precise information about the level of damages sought by investors and the awards rendered is scarce and difficult to obtain, it is clear that some claims involved large amounts. For example: the Czech Republic's award of some US$270 million plus substantial interest in the Lauder case; the award in **CSOB versus Slovakia** (29 December 2004) of US$824 million plus an additional US$10 million as partial contribution to CSOB's costs; or Occidental's 2002 award against Ecuador of US$71 million plus interest). But not all claims lead to the requested awards being granted. The amount awarded for a claim is not necessarily an indication of the real financial magnitude of a case, since there are no penalties for claimants filing particularly high claims. Very large claims often end up yielding very small awards. The **Metalclad versus Mexico** claim for US$43 million, for example, led to an award of less than US$17 million, and S.D. Myers, in its US$70-80 million claim against Canada, was awarded US$6 million, i.e. less than 10 per cent of the amount sought. A significant number of cases are won by States and no damages are awarded to the claimant.

However, even defending oneself against claims costs money. Investment treaty arbitration proceedings are expensive. The Metalclad Corporation is reported to have spent some US$4 million on lawyers' and arbitrators' fees in a case against Mexico. The Czech Republic reportedly spent US$10 million on its defense against two major claims brought by a European-based broadcasting firm and one of its major shareholders. More recently, the Czech government announced expected legal fees of US$3.3 million in 2004, and US$13.8 million next year, to fight off similar claims. A cursory review of cost decisions in recent awards suggests that the average legal costs incurred by governments are US$1-2 million, including lawyers' fees; the costs for the tribunal, about US$400,000 or more; and the costs for the claimant about the same as for the defendant.

Source: UNCTAD (2005d).

4 The concept of national policy space

One of the key objectives of countries negotiating IIAs is to increase the flows of FDI between the contracting parties. In addition, home countries (and their investors) seek transparency, stability, predictability, security and greater market access. Host developing countries, for their part, seek to advance their economic and social development by attracting development-enhancing FDI and benefitting from it. In order to maximize benefits from FDI, countries need to have flexibility to use a range of development-oriented policies. In this context questions about the right balance between rights and obligations of the parties concerned, between private and public interests in IIAs, are an important aspect.

The concept of "national policy space" refers to flexibility for governments to pursue development-oriented policies. Its foundation is the right to regulate, a sovereign prerogative that arises out of a State's control over its own territory and that is a fundamental element in the international legal regime of State sovereignty.

IIAs, like other legal texts, contain obligations that limit the sovereign autonomy of the parties. Given that international legal obligations generally prevail over domestic rules, tension can arise between the will to cooperate at the international level through binding rules and the need for governments to discharge their domestic regulatory functions (see examples of relevant ISDS cases in box 34). That is why there is a need to ensure coherence between the international commitments of a country, on one hand, and its national policies and measures for pursuing development objectives, on the other hand.

5 The development dimension in IIAs

The development dimension in IIAs is the result of negotiations in light of overlapping – but not identical – objectives between home and host countries. Ensuring sufficient flexibility for pursuing development objectives and related policies is a difficult balancing act. While many IIAs do not expressly deal with development issues, several state in general terms that, by concluding the agreement, the parties seek to advance economic development. Some other IIAs contain numerous provisions with references to the parties' development objectives. In general terms, the development dimension may find expression in the objectives, structure, content, and implementation of IIAs, as well as the use of various exceptions for development goals.

5.1 Objectives

Many IIAs incorporate the objective of development among their basic aims, purposes or principles, as a part of their introductory statements or as specific declaratory clauses articulating general principles (see examples in box 36). The key function of such provisions (e.g. a preamble) is to guide the interpretation of the agreement's other provisions. In other words, it can help foster a more development-friendly interpretation. However, it must be kept in mind that where substantive provisions of a treaty are specific enough, they will be given priority over generalized principles contained in its preamble.

Box 36

Development objectives in IIA preambles

The Preamble of GATS (1994)
The Preamble of the GATS Agreement (which covers commercial presence/FDI in services) includes among its objectives "the expansion of [services] trade under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries". It also expresses a desire for the "early achievement of progressively higher levels of liberalization of trade in services through successive rounds of multilateral negotiations aimed at promoting the interests of all participants on a mutually advantageous basis and at securing an overall balance of rights and obligations, while giving due respect to national policy objectives". It continues by expressing a further desire, "to facilitate the increasing participation of developing countries in trade in services and the expansion of their service exports including, *inter alia*, through the strengthening of their domestic services capacity and its efficiency and competitiveness".

The Preamble of CARIFORUM-EC EPA (2008)
The Preamble of the Economic Partnership Agreement between the Carribean Forum of African, Carribean and Pacific States (CARIFORUM) and the European Community (EC), an agreement with substantial provisions on Investment, repeatedly and in detail refers to development in its objectives. More precisely, the preamble sets out a sustainable development objective which includes "economic, cultural and social aspects", "protecting the environment", "respecting basic labour rights" and other relevant international commitments such as the United Nations Millennium Development Goals and 2002 Johannesburg Declaration.

Excerpts include the following:
"CONSIDERING the need to promote and expedite the economic, cultural and social development of the CARIFORUM States, with a view to contributing to peace and security and to promoting a stable and democratic political environment;
CONSIDERING the importance that they attach to the internationally agreed development objectives and to the United Nations Millennium Development Goals;
CONSIDERING the need to promote economic and social progress for their people in a manner consistent with sustainable development by respecting basic labour rights in line with the commitments they have undertaken within the International Labour Organization and by protecting the environment in line with the 2002 Johannesburg Declaration;
REAFFIRMING their commitment to work together towards the achievement of the objectives of the Cotonou Agreement, including poverty eradication, sustainable development and the gradual integration of the African, Caribbean and Pacific (ACP) States into the world economy; [...]
CONSIDERING the difference in levels of economic and social development existing between the CARIFORUM States and the European Community and its Member States"

Source: GATS (*http://www.wto.org/english/docs_e/legal_e/26-gats.pdf*); CARIFORUM-EC EPA (*http://ec.europa.eu/world/agreements/downloadFile.do?fullText=yes&treatyTransId=12969*).

5.2 Structure

The structure of agreements may reflect development concerns through the application of special and differential treatment for developing countries. This entails differences in the extent of obligations undertaken by developed and developing country parties, with the latter assuming less onerous obligations, either on a temporary or permanent basis, that are also not reciprocal. This may be achieved in a number of ways:

- Agreements can distinguish between developed and developing countries, with different obligations for both. The MIGA, for example, restricts its investment insurance to investment in developing countries only, listed in an annex to the MIGA Convention.

- Differences may be introduced for stages and degrees of participation by developing country parties, with accession less onerous for them or allowing for association rather than full commitment to treaty obligations.[35]

5.3 Content

For every key substantive issue, more development-friendly or less development-friendly solutions exist. And given their importance, they require the full attention of negotiators.

When negotiating content, flexibility can be introduced through various means:

- **Excluding some issues.** For example, excluding provisions on incentives from the draft MAI will allow countries to have maximum policy flexibility in this area (consistent with other international obligations). Most IIAs exclude taxation issues (covered in double taxation treaties).

- **Circumscribing the scope** of key provisions – for instance – by limiting the definition of investment to FDI only, or by including an explicit requirement that in order to be covered by the IIA, an investment must contribute to the economic development of the host State.[36]

- **Including provisions of special interest to developing countries**, such as those pertaining to transfer of technology or home country measures.[37]

- **Using various kinds of exceptions**, reservations, derogations and waivers to transition arrangements that aim to ensure that signatories retain their prerogative to apply non-conforming domestic regulations in certain areas. Examples include exclusions from the non-discrimination principle; safeguards aimed at preserving the right to regulate, as in balance-of-payments difficulties; and general exceptions for reasons of public security and order, public health and morality.

5.4 Implementation

The implementation of IIAs can also be designed with flexibility for development as its organizing principle. Two approaches are particularly relevant here:[38]

- Whether an agreement is **legally binding** or not affects the intensity of particular obligations. Indeed, it is possible to have a mix of binding commitments and non-binding "best effort" provisions in one agreement. Thus, development-oriented provisions could be either legally binding or non-binding (hortatory), depending on the extent to which the parties are willing to undertake commitments in this area.

- The asymmetries between developed and developing country parties to IIAs can be tackled by commitments addressed to the developed country parties to undertake measures of assistance to the developing, and especially LDC, parties. A leading example, as noted (Module 2, theme 1) is the technology transfer commitment by developed country parties to the TRIPS Agreement towards LDCs. Such developed country commitments can be complemented by provisions for technical assistance through relevant international organizations. Also capacity building with respect aimed at improving developing countries' regulatory and institutional framework can offer important development benefits, particularly in the context of agreements that aim at the liberalization of specific areas of economic activities (e.g. services sectors).[39]

- All of this is particularly important, given the complexity of the subject matter and the limited capacity of many developing countries, especially the LDCs, to undertake FDI-related policy analysis.

6 Ensuring coherence of national and international investment policies

Each government can evaluate the trade-off between the benefits of accepting international rules and commitments and the constraints

[35] This approach tends to be found more frequently in agreements focussing in liberalisation as opposed to protection.

[36] See UNCTAD (2010b). "

[37] See UNCTAD (2008c).

[38] See UNCTAD (2000).

[39] See UNCTAD (2009a, 2010c).

posed by the loss of policy space. As mentioned above, flexibility can be ensured in different ways when designing and negotiating an IIA. Once international commitments are undertaken, coherence between national and international investment policies has to be ensured during the implementation of the agreement.

IIAs are usually in force for many years. During this time, some of the host country's newly enacted policies and measures taken might interfere with its obligations in pre-existing IIAs. After a policy choice has been made and is reflected in an international agreement, significant policy changes which take place in the time-frame of an agreement could be contrary to the initial commitment and thus be a violation of certain provisions set out in the agreement (see box 33). If the host country for example, wishes to open some sectors to FDI while preserving its full control for other sectors, there is a need to carefully identify the sensitive sectors, before the conclusion of an agreement, preferably within the framework of strategic planning, which shoulbe be preceded by careful assessments and evaluation studies. It could be difficult for the respective country to withdraw from liberalization commitments once they have been made at the international level.

Therefore, international commitments in IIAs also require sustainable policy orientations: clear and stable policy objectives, sectoral strategies correlated with these objectives and between themselves, as well as realistic implementation plans and measures. The coherence of policy positions at the national and international levels helps to avoid possible contradictions between host country's national policies and the ratified IIAs and thereby prevents conflicts with investors. By contrast, a lack of coherence between national policies and international commitments can lead to disputes with foreign investors and have significant drawbacks, particularly for developing countries, in terms of high costs, long duration, and the damage that such proceedings may cause to the investor-State relationship and the country's reputation as an investment destination.

It must be kept in mind that coherence must also be ensured between different international agreements signed by a country. Indeed, each IIA is part of a larger set of investment agreements at bilateral, regional, interregional or plurilateral levels and addresses a broad range of issues related to investment and the operations of business enterprises. When the same parties participate in various agreements, their respective provisions also interact, complement, elaborate, expand or limit these parties' obligations. When designing IIAs, it is therefore important, to bear in mind this broader context, and ensure that the standards, exceptions and other issues that the parties seek to negotiate in agreements would not be modified or otherwise affected by other agreements in unintended ways.

When the parties desire to ensure no conflict of compatibility arises between an IIA and other economic agreements to which the signatory States may be a party, they can do so by inserting specific clauses into the agreement expressing this intent. Examples of such clauses include the "regional economic integration organization" clause, which ensures that the benefits of membership of such an organization are not extended to non-member countries on the basis of the IIA's most favoured nation clause, and the preservation of rights clause found in BITs (for more details, see Module 3).

Today IIA rule-making is taking place in an environment with novel challenges arising, for example in the context of climate change or the global financial crisis. It is therefore important to address the question how investor protection standards in IIAs should interact with countries' existing – or future – environmental and other obligations at the international level. Coherence between different bodies of international law and policy is one of today's a key policy objective.

Finally, ensuring coherence is also a challenge for future national policies and international negotiations. Countries can use the lessons learned from the implementation of various IIAs and existing arbitral awards to further clarify and improve their policy positions for new treaties, including through enhancing, the development dimension where necessary. Countries can also learn from the experiences of other States, through monitoring the developments in the international regulatory framework for investment. For instance, the concerned departments in trade and investment ministries could monitor the evolution of dispute settlement cases through consulting the documents made public in this respect by ICSID or various international publications in this field; or they can, in a broader view, engage in capacity building programmes through participating in various international expert meetings, workshops or conferences on international investment law.

7 Conclusion

In the past few decades, international rules for FDI have changed significantly, based mainly on the change of perception regarding FDI. It is now generally agreed that the many facets of the legal regulation of FDI are a matter of international concern.

The international legal framework for FDI is fluid, primarily because there is no established general consensus on its optimal content. As a result, there is no comprehensive global instrument. In compensation, bilateral and regional agreements have in the recent past taken the lead in creating international rules for investment. Their number has progressively increased, and their provisions are becoming more and more complex.

In this context, and upon negotiating these agreements, developing countries have multiple challenges to address. A priority should be to keep a balance between the diverging interests and priorities of the countries that negotiate with them and their national development objectives. In other words, they must address the challenge of preserving their right to regulate and at the same time create favourable conditions to attract FDI. The national policy space can be preserved through various means, when designing and negotiating an IIA. In this sense, countries should bear in mind the need for precision and coherence when negotiating and drafting, as the lack of it thereof may result in costly disputes.

Exercises and questions for discussion

1. What is an international investment agreement?
2. What are the main objectives of IIAs?
3. Who are the three main actors involved in and affected by IIAs? Who else could possibly be affected in a country signing an IIA?
4. What is the difference between an international investment instrument and an international agreement on investment?
5. What is the difference between a plurilateral and a multilateral agreement in the WTO?
6. Name the main types of international agreements dedicated exclusively or mainly to investment. Name other types of agreements that concern investment. Use the UNCTAD database to see the IIAs your country has concluded.
7. Using box 28, name the main provisions usually found in BITs.
8. Give reasons why countries conclude BITs with one another. Taking your home country as an example, what do you think are the main reasons why it has concluded BITs.
9. What are DTTs? Explain how DTTs relate to foreign investment.
10. What are EIAs and what is their main purpose? Name the different types of EIAs and discuss their main features.
11. Is your country party to an EIA? Find an EIA from your region.
12. What is a REIO? What powers can it have?
13. Name some of the failed attempts to create a multilateral framework for investment and discuss the possible reasons for such failures.
14. Give examples of adopted multilateral agreements with investment-related provisions.
15. Discuss the main trends in the number and features of BITs since 1990.
16. What are the main features linked to the growth of IIAs other than BITs and DTTs?
17. What could be reasons for countries negotiating investment rules as part of a broader agreement instead of a self-standing BIT?
18. Describe South-South cooperation on investment issues. What are possible reasons behind this trend? What are possible development benefits?
19. Name the main recent trends in IIAs. Discuss in groups possible implications for the IIA regime and for investment policy-making more broadly.
20. Describe the key features of investor-State dispute settlement.
21. Describe the recent evolution of international investment disputes.
22. Discuss the broader public policy issues that ISDS cases raise.
23. Define the concept of national policy space. How can IIAs restrict national policy space?
24. What are the main ways in which a country can preserve flexibility for development when negotiating an IIA?
25. What mechanisms other than flexibility can be envisaged to help generate development benefits from IIAs?
26. Name the main policy aspects to be taken into consideration by a host country at the implementation of an IIA.

Exercises and questions for discussion

27. Practical exercise

Balancing national interests and international commitments: The experience of Argentina after the financial crisis

At the beginning of the 1990s, Argentina introduced a large-scale programme to privatize public utility firms. By 1994, over 90 per cent of State enterprises had been privatized including the telephone, electricity, gas and water utilities. Pursuant to the regulatory framework adopted as part of the privatization process in order to attract foreign investors in the utility sector, companies were granted long-term licenses with the right to calculate tariffs in US dollars and to convert them into pesos at the prevailing exchange rate at the time of billing. In addition, the tariff regime included the right to have tariffs adjusted every six months under a key US inflation index. As part of Argentina's broader approach to create economic stability and prosperity, the country also pegged its local currency to the US dollar with an exchange rate of 1:1. During the same decade, Argentina signed 54 BITs to provide security and guarantees for foreign investors.

Problems began to surface when economic conditions in the country deteriorated. Economic contraction, massive withdrawals of banking deposits and a rapid decline in international reserves forced the Government in January 2002 to abrogate the convertibility law that fixed the peso's exchange rate at par with the US dollar. The resulting trebling of the value of the dollar in local currency (in the matter of days, the peso declined in value by almost 70 per cent) and the deep economic recession, led the government to transform dollar-denominated contracts into peso-denominated contracts. This included licenses granted to public utility firms. The periodic adjustments of public utility tariffs based on the US inflation index were also eliminated. In effect, Argentina abrogated the main features of the regulatory and contractual framework that it had introduced in the early 1990s.

In the following months a number of foreign investors resorted to arbitration at ICSID and other fora. Indeed, 37 out of more than 40 arbitration cases that the Argentine Government faced as a respondent were registered after the introduction of the emergency measures in 2002 and are related, at least in part, to the country's grave financial and economic crisis. Investors claimed damages, often in excess of US$100 million, on the grounds that Argentina's abrogation of its regulatory and contractual framework violated BITs' fair and equitable treatment standard and the umbrella clauses, constituted discriminatory and arbitrary conduct and an indirect expropriation of their investments.

In its defense, Argentina maintained that "it has not offered any guarantee concerning the maintenance of the convertibility system and in case of devaluation of its currency, because the Government could not have assumed an obligation to follow any specific economic or exchange policy since it can freely modify those policies." In Argentina's view, its actions had been rendered necessary by an imminent economic, financial and social crisis in the country, and it thus referred to a state of necessity. Argentina has also contended that "the emergency measures adopted by the Government are to be considered as economic policy regulatory measures that do not give right to compensation. They were instrumented through legislative acts of general scope, non-discriminatory, and therefore applicable to both Argentine and foreign nationals without any distinction. They are temporary in nature and oriented at the protection of public welfare interests, with a view to normalize the life of the country, to guarantee the continuity of public utilities and to keep rates for customers at an affordable level."

At the same time, the government was negotiating gradual tariff increases with privately owned public utilities on a condition that the investors withdraw their international claims. At least one complainant withdrew its complaint in April 2005.

An ICSID tribunal rendered a first award in a crisis related case on 12 May 2005.[40] The tribunal ordered Argentina to pay US$133.5 million plus interest in compensation to a US company, on the grounds of breach of contract and violation of the BIT between Argentina and the US. The tribunal rejected Argentina's arguments based on a state of necessity as well as on the investor's contention that it had suffered an indirect or regulatory expropriation of its investment. This damages award was later upheld by the ICSID Annulment Committee despite the fact that the committee identified errors in the findings of the original tribunal.[41]

[40] *CMS Gas Transmission Company vs Argentine Republic*, ICSID Case No. ARB/01/8, Award of 12 May 2005.

[41] *CMS Gas Transmission Company vs Argentine Republic,* ICSID Case No. ARB/01/8, Annulment Decision of 25 September 2007.

[42] In addition to the CMS case, these are *Enron Corporation and Ponderosa Assets, L.P. vs Argentine Republic*, ICSID Case No. ARB/01/3, Award of 22 May 2007; *Sempra Energy International vs Argentine Republic*, ICSID Case No. ARB/02/16, Award of 28 September 2007; *BG Group Plc vs Argentine Republic*, UNCITRAL, Final Award of 24 December 2007.

[43] *LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. vs Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability of 3 October 2006, Award of 25 July 2007; *Continental Casualty Company vs Argentina*, ICSID Case No. ARB/03/9, Award of 5 September 2008.

Exercises and questions for discussion

To date, more than half a dozen arbitration rulings have been handed down by tribunals in Argentine crisis cases. Arbitrators have tended to agree that Argentina's emergency measures breached its BIT obligations, but diverged sharply on whether those measures – and the resulting BIT breaches – could be excused due to the economic emergency that dictated their introduction (the so-called "necessity defense"). Some tribunals rejected Argentina's plea and ordered compensation[42] while others accepted it and absolved Argentina from liability during the relevant period.[43]

Questions:

- What measures were taken by the Argentine Government to attract FDI in its public utility sector?
- How did the economic crisis affect the government's ability to continue implementing such measures?
- Form two groups and have a discussion using the arguments brought by the Argentine authorities in justification of its emergency measures (group 1) and possible arguments from the point of view of foreign investor group (group 2).
- Discuss how Argentina's experience relates to the concept of national policy space.

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MODULE 3

Key issues and features in International Investment Agreements

INTRODUCTION TO MODULE 3

International investment agreements are international treaties and as such they are part of international public law. The main objective of these treaties is the promotion and protection of foreign investments in the respective parties' territories through the creation of an international legal framework. This framework gives foreign investors certain guarantees with regard to their investments within these territories.

IIAs can be bilateral, regional, plurilateral or multilateral. They may cover all sectors of the economy or be limited to a specific sector, such as, the Energy Charter Treaty. IIAs can also take the form of a chapter in a regional integration or free trade agreement. However, the architecture of most of them follows similar patterns.

IIAs traditionally cover the following key issues:

- Scope and definition of investment;
- Admission and establishment;
- Treatment (national treatment, most-favoured-nation treatment and fair and equitable treatment);
- Compensation in the event of expropriation or damage to the investment;
- Guarantees of free transfers of funds; and
- Dispute settlement mechanisms, both State to State and investor to State.

Most recently, IIAs have included environmental and employment provisions with the primary objective to avoid attracting foreign investments through the liberalization of environmental and labor standards.

Theme 1
Scope and definition of investment

INTRODUCTION

The main purpose of definitions included in an international investment agreement is to specify their geographical, temporal and subject-matter coverage. Consequently, definitions are key for delineating the scope of the IIA. This chapter analyses the scope of the application of IIAs, as well as the definitions that delineate them. The scope of application determines its coverage with respect to investments and investors in a specific space and time. IIAs typically apply to investment in the territory of one country by investors of another country.

At the end of this theme, students should be able to:

- Understand the significance of the scope of application and its definition;
- Identify and distinguish between coverage of IIAs in various subject-matters;
- Identify the assets to which the treaty applies;
- Identify the different forms in which a definition can delineate the scope of application;
- Evaluate the nature of obligations created by the treaty;
- Analyze in what ways the scope of application can be narrowed down; and
- Draft definitions and propose different policy options regarding the definition of the investment and the investor.

HANDBOOK

1 Scope of application

The scope of application of an IIA determines its coverage with respect to investments and investors in a specific space and time. It is delineated primarily through the definitions of territory, investment and investor. Provisions establishing the entry into force of the treaty and its duration determine the temporal coverage of the agreement.

Box 37

Scope of an IIA
Matter coverage: defines those assets to which the treaty applies
Subject coverage: defines those persons and legal entities to which the treaty applies
Geographical coverage: defines the territory to which the treaty provisions apply
Temporal coverage: determines the date of entry into force of the IIA and its duration

These definitions, in conjunction with the substantive IIA rules, determine the nature and scope of the obligations created by the treaty.

2 Matter coverage: definition of investment

In the context of IIAs, an investment definition specifies the assets – or economic activities – to which the operative provisions of the agreement will apply. It includes, with a few exceptions, both direct and portfolio investments (refer to Module 1, theme 1 for term definitions).

The concept of "investment" has evolved over time due to changes in the nature of international economic relations and has had an impact on investment policies. For example, the link between portfolio investments and economic crises has raised doubts on utilization of a definition that includes this kind of investment. The type and form of assets to be included in the definition may also depend on the type of agreement. For example, an IIA that deals with rules on admission may define investments differently than one that deals with post-admission treatment (refer to Module 3, theme 2).

Currently, IIAs' definition of "investment" falls into three broad categories:

- Asset-based;
- Enterprise-based;
- Transaction-based.

In some cases IIAs mix these categories in a hybrid definition.

2.1 Asset-based definition

The asset-based definition is a common approach in IIAs. Investments are defined with a compact formula that includes "all categories of assets" and "all categories of rights and interests". In many cases, the definition is a broad one that includes all assets in the territory of one country owned by investors of another country.

Many IIAs have adopted a more precise definition that not only includes the above-mentioned formula, but also an illustrative list of five categories of investments:

- **Movable and immovable property:** includes goods and other tangible property, as well as land and legal interests in property that are less than full ownership (property rights such as mortgages, liens and pledges).

- **Various types of interest in companies:** This does not require that the investor's interest or participation in the company be a controlling one. It therefore includes not only FDI, but also portfolio investment, and debt instruments that may include bonds issued by public agencies.

- **Claims to money and claims under a contract having a financial value:** includes property rights and contractual rights, for instance, for the performance of services.

- **Intellectual Property Rights:** includes trademarks, trade secrets, patents, copyrights, technical process, know-how, goodwill and reputation of the company.

- **Business concessions, including natural resources concessions:** includes primarily privileges or rights granted to private parties by a government through special administrative or legislative action.

Although these five categories are common to many IIAs, they can vary. Since this list is merely illustrative it ensures certain flexibility in the treaty's application. For example, an interest that does not fall within any of the five categories is nevertheless an investment if it can be considered as an asset.

Box 38

Example of asset-based definition: BIT China – Germany, 2003

Article 1: Definitions

For the purpose of this agreement the term "investment" means every kind of asset invested directly or indirectly by investors of one contracting party in the territory of the other contracting party, and in particular, though not exclusively, includes:
(a) movable and immovable property and other property rights such as mortgages and pledges;
(b) shares, debentures, stock and any other kind of interest in companies;
(c) claims to money or to any other performance having an economic value associated with an investment;
(d) intellectual property rights, in particular copyrights, patents and industrial designs, trade-marks, trade-names, technical processes, trade and business secrets, know-how and goodwill;
(e) business concessions conferred by law or under contract permitted by law, including concessions to search for, cultivate, extract or exploit natural resources; any change in the form in which assets are invested does not affect their character as investments.

2.2 Enterprise-based definition

One alternative approach is to focus on the "business enterprise" or the "controlling interests in a business enterprise". According to this approach investment includes the establishment or acquisition of a business enterprise, as well as a share in a business enterprise, which gives the investor control over the enterprise. This type of definition is referred to as an "enterprise-based" definition and is narrower than the one provided by the asset-based approach because it does not include, for example, portfolio investments (refer to 3.2 in this module).

Box 39

Example of enterprise-based definition

Article XXVIII(d) of the GATS provides an enterprise-based definition which apply only to investments in the form of a commercial presence:
"Commercial presence" means any type of business or professional establishment, including through the constitution, acquisition or maintenance of a juridical person, or the creation and maintenance of a branch or a representative office, within the territory of a member for the purpose of supplying a service.

2.3 Transaction-based definition

Another alternative to the asset-based approach is to omit the reference to assets and to include instead an enumeration of the transactions covered. For example:

- Creation, extension, acquisition of full ownership;
- Participation;
- Loans over a certain duration etc.

The transaction-based definition is conceptually different from the asset-based definition. Its approach to investment considers only the transaction of establishing or liquidating an investment, not the protection of assets. This is where the important point of distinction between asset- and transaction-based definitions emerges.

Box 40

Example of transaction-based definition

The OECD Code of Liberalisation of Capital Movements does not define the term "investment" as such, but contains a list of capital movements to be liberalised. This list includes, among others, direct investment.

3 Subject coverage: definition of investors

An important issue that arises in determining the scope of an IIA is the nature of the relationship that must exist between the investment to be covered and the investor. IIAs generally do not apply to all foreign investment. They apply typically only to investment *of* or *by* investors who qualify for coverage. Therefore, the definition of investor is critical in determining the scope of an IIA.

In the practice of IIAs, the definition of investor commonly includes natural persons and legal persons (or juridical entities). Some IIAs refer to nationals and companies, with the former defined to include native people and the latter defined to include a range of legal entities.

3.1 Definition of natural persons

Two different approaches have been taken in the drafting of the definition of an investor:

- Nationality (common practice);
- Domicile or residence.

3.1.1 Nationality (common practice)

According to this criterion, a natural person is considered as an investor within the meaning of an IIA only if this person is **a national of the treaty partner.**

The common practice in IIAs (as in more general international practice) is that a natural person possesses the nationality of a State if the law of that State provides so. Therefore, the term "national" is defined commonly by reference to the parties' constitutions and/or domestic laws on nationality. While some IIAs set forth a common definition, which applies to both parties, other IIAs provide a specific definition for each treaty partner.

Box 41

Example of nationality criterion: BIT China – Germany, 2003

Article 1: Definitions

2. The term "investor" means

(a) in respect of the Federal Republic of Germany: Germans within the meaning of the Basic Law for the Federal Republic of Germany (...)

(b) in respect of the People's Republic of China: natural persons who have the nationality of the People's Republic of China in accordance with its laws (...)

In this context it is important to point out two issues that are not explicitly addressed by most IIAs:

- The problem that arises when a covered investor possesses the nationality of both treaty partners (dual nationality);
- The case where a covered investor changes his/her former nationality.

Concerning the first question, if the IIA does not address the question, international law applies. Under customary international law, a State could exercise diplomatic protection on behalf of one of its nationals with respect to a claim against another State, even if its national also possessed the nationality of the other State, provided that the dominant and effective nationality of the person was of the State exercising diplomatic protection. According to this principle, the dominant and effective nationality of the investor would prevail over any other.

With regard to the second question, changes of nationality imply changes of the status granted by the IIA. If the investor has enjoyed the protection of the IIA due to his/her nationality, this protection could not be granted after he/she changes his/her nationality. Therefore, changes in the nationality of an investor will result in the loss of treaty protection for an investment owned by the investor.

3.1.2 Domicile or residence

According to this criterion, a native person is considered as an investor within the meaning of an IIA if this person has his/her **domicile or permanent residence in the territory of the treaty partner.**

This criterion can be used in IIAs not only as an alternative but also in addition to a nationality link. For example, high immigration countries (e.g., Australia, Canada and the US), in which a considerable proportion of the economically active population may not yet be full citizens, regularly extend a special legal status to permanent residents.

Box 42

Example of domicile or residence criterion: BIT Canada – Argentina, 1991

Article 1: Definitions

b) The term "investor" means any natural person possessing the citizenship of or permanently residing in a contracting party in accordance with its laws, (...) who makes the investment; (...).

3.2 Definition of legal entities

Although the term "nationality" applies only to native citizens, IIAs take three different approaches in order to determine the nationality of legal persons:

- Country of organization or incorporation;
- Country of seat;
- Country of ownership or control.

IIAs often combine these criteria.

3.2.1 Country of organization or incorporation

According to this criterion, a legal person is considered as an investor within the meaning of an IIA if it has been **incorporated or organized in the territory of the treaty partner.**

This criterion, however, has advantages and disadvantages. Since the country of organization or incorporation cannot be changed easily, there is usually no doubt concerning the nationality of the legal person; but, on the other hand, since this approach relies on a relatively insignificant link between the legal entity and the country of incorporation, it may cause some problems that companies that are not engaged in economic activities in that country claim protection under the treaties concluded by it.

For this reason, some IIAs – e.g. the model BIT used by the US – allow the host country to refuse to extend treaty protection to investment owned by investors of the other party if the investors do not have substantial business activities in the territory of the other party.

Box 43

Extent of treaty protection: USA BIT model, 2004

Article 17: Denial of Benefits

2. A party may deny the benefits of this treaty to an investor of the other party that is an enterprise of such other party and to investments of that investor if the enterprise has no substantial business activities in the territory of the other party and investors of a non-party, or of the denying party, own or control the enterprise.

3.2.2 Criterion of the seat

According to this criterion, a legal person is considered as an investor within the meaning of an IIA if its **effective management takes place in the territory of the treaty partner.** Under this approach the actual management determines the nationality of the legal person.

Box 44

Example of criterion of the seat: BIT China – Germany, 2003

Article 1: Definition

2. The term "investor" means
in respect of the Federal Republic of Germany: any juridical person as well as any commercial or other company or association with or without legal personality having its seat in the territory of the Federal Republic of Germany, irrespective of whether or not its activities are directed at profit (...).

This criterion reflects a more significant economic relationship between the company and the country of nationality than the criterion of incorporation.

3.2.3 Criterion of ownership or control

According to this criterion, a legal person is considered as an investor if it is **owned or controlled by a national of the treaty partner**. Under this approach the nationality of the shareholders who own or control the legal person determines its nationality.

Box 45

Example of criterion of ownership or control

Andean Community – Decision 291 Regime for the Common Treatment of Foreign Capital and Trademarks, Patents, Licensing Agreements and Royalties:

Article 1: For purposes of the present regime, the following definitions shall apply:
Foreign Enterprise: an enterprise incorporated or established in the recipient country, in which national investors own less than fifty one per cent of the equity capital or, if more than that, in the judgment of the competent national agency that percentage is not reflected in the technical, financial, administrative and commercial management of the enterprise.

Only a few investment agreements define the terms "own or control". It can be described in quantitative and qualitative terms:

- Where ownership is described in quantitative terms, some agreements require at least 50 per cent ownership.

- Where ownership or control is described in qualitative terms, it is defined as having “a substantial share of ownership rights and the ability to exercise decisive influence”. Definitions of ownership or control in qualitative terms generally do not require majority or any specific quantum of ownership.

The definition of "own or control" in qualitative terms reflects the fact that effective control of a company is often exercised by shareholders who own less than half of the stock. By lowering the requirement to less than majority ownership, a treaty makes it easier for an investor to have the necessary relationship with an investment to bring the investment within the coverage of the treaty and thus broadens the scope of the treaty. In this context it is important to point out two issues that may arise:

- Issues in determining the nationality of the legal person in the case of companies whose stock is traded on major stock exchanges.

- The problem that may arise when a legal person is controlled directly or indirectly by another national that operates in a third country that is not a country party to the IIA (e.g. transnational corporations).

For this reason, the criterion of ownership or control is commonly used in conjunction with one of the other criterion. However, it should be noted that a significant number of internationally active enterprises can be excluded from the scope of an IIA through the cumulative use of the various above-mentioned criteria. This is a matter of greater importance to bilateral rather than multilateral agreements, because the latter tend to allow for “cumulation of nationality” among countries party to the agreement.

Box 46

Example of combined criteria: BIT China – Germany, 2003

Article 1: Definition

2. The term "investor" means in respect of the People’s Republic of China:

economic entities, including companies, corporations, associations, partnerships and other organizations, incorporated and constituted under the laws and regulations of and with their seats in the People’s Republic of China, irrespective of whether or not for profit and whether their liabilities are limited or not.

4 Geographical coverage

Investments are covered by an IIA only if they take place in the **territory** of one of the States’ parties to an agreement. The definition of "territory" includes generally the land territory and the maritime zones over which the host country exercises rights or jurisdiction in conformity with international law.

It is important to point out that inclusion of maritime zones in the definition over which the host country exercises jurisdiction is significant in this context because it extends the application of the IIA to those investments located within the host country’s maritime jurisdiction, such as mineral exploration or extraction facilities.

Box 47

Example of territory definition: BIT Canada – Ecuador, 1996

Article 1: Definitions

For the purpose of this Agreement: (...) "territory" means:

in respect of Canada, the territory of Canada, as well as those maritime areas, including the seabed and subsoil adjacent to the outer limit of the territorial sea, over which Canada exercises, in accordance with international law, sovereign rights for the purpose of exploration and exploitation of the natural resources of such areas;

in respect of Ecuador, the national territory of Ecuador, including the territorial sea, those maritime areas adjacent to the outer limit of the territorial sea, where it may, pursuant to its legislation and international law, exercise sovereignty, sovereign rights or jurisdiction.

5 Temporal coverage

Provisions that establish the entry into force of the treaty and its duration determine the temporal coverage of the agreement. In this context two issues may arise:

- The application of the IIA to investments established prior to its entry into force;
- The application of the IIA after its termination to those investments which are made while the treaty is still in force.

Concerning the first issue, the most recent IIAs extend protection not only to investments that are made after the entry into force of the IIA, but also to those that are made before this date. Some IIAs, however, exclude this coverage to those disputes that have emerged before the entry into force of the agreement.

With regard to the second question, most IIAs usually include a clause that extends its protection from a period ranging from 10 to 20 years for investments made while the treaty is in force and will continue after its termination.

Box 48

Example of temporal coverage: BIT China – Germany, 2003

Article 16: Transition

(1) Upon entry into force of this agreement the agreement of 7 October 1983 between the Federal Republic of Germany and the People's Republic of China on the Encouragement and Reciprocal Protection of Investments shall terminate.

(2) The present agreement shall apply to all investments made by investors of either contracting party in the territory of the other contracting party, whether made before or after the entry into force of this agreement, but shall not apply to any dispute or any claim concerning an investment which was already under judicial or arbitral process before its entry into force. Such disputes and claims shall continue to be settled according to the provisions of the agreement of 7 October 1983 mentioned in para. 1 of this article.

6 Narrowing the scope of application

Since the scope of application of an IIA depends on the purpose of the agreement (e.g. to promote, protect or control foreign investment), some IIAs may include various limitations on the scope of investments covered. IIAs aiming to control cross-border movement of capital and resources usually define "investment" in narrow terms, while those that tend to protect and promote foreign investments generally use a broad and comprehensive definition of investment. IIAs can limit definitions in various ways:

- **Limitations to permitted investments under host country law:** investments are covered only if they are made in accordance with the laws of the host country or if host State officials previously approve them;
- **Limitations on time of establishment:** exclude investments established prior to a certain date;
- **Limitations on the nature of the investment:** exclude certain types of investments, for example: portfolio investment, investments by public bodies or agencies;
- **Limitation on the size of investment:** provides coverage only to investments involving a certain minimum of capital;
- **Limitation on the sector of the economy:** a host country may wish to limit treaty coverage to investments in certain sectors of the economy.

Box 49

Example of limitations to definition: BIT China – Germany, 2003

1. Ad Article 1

(a) For the avoidance of doubt, the contracting parties agree that investments as defined in Article 1 are those made for the purpose of establishing lasting economic relations in connection with an enterprise, especially those which allow to exercise effective influence in its management.

(b) "Invested indirectly" means invested by an investor of one contracting party through a company which is fully or partially owned by the investor and having its seat in the territory of the other contracting party.

(c) Returns from the investment and from reinvestments shall enjoy the same protection as the investment.

Exercises and questions for discussion

1. What types of definitions may an IIA provide, and what are their features?
2. What is included in the asset-based definition of investments?
3. In the asset-based definition of investments, is it possible to include other forms of investments, although they are not explicitly mentioned there?
4. What are the merits and possible shortcomings of the different definitions of an investment?
5. What are the main features of the investor definition in IIAs?
6. If a natural person has a double nationality (including the nationality of a non-treaty partner), can he/she claim treaty protection?
7. Imagine that a legal person, which has been established in country A and which is controlled by nationals of country B, makes an investment in country C. Which problem could arise in this case?
8. If an investment has taken place prior to the entry into force of a treaty, can the investor claim the protection of the treaty? Explain your answer.
9. If a dispute has arisen prior to the entry into force of a treaty, can the investor claim protection?

Exercises and questions for discussion

10. Give an example of cases where a country might have an interest in narrowing the scope of application of the treaty.

11. Taking into account the policies regarding investment of your country, draft a definition of investments and investors.

12. Practical exercise

Identify and analyze the main features of this definition. What type of definition is it?

Article 1:
For the purpose of the present Treaty,
(1) The term "investments" shall comprise corporate shares and other kinds of interest in companies, and all other assets connected with economic activity, in particular:

(a) Property and other rights *in rem;*
(b) Claims to money which has been used to create an economic value or claims to any performance having an economic value;
(c) Copyrights, industrial property rights (such as patents for inventions, trade marks), technical processes, know-how and goodwill.

Any alteration of the form in which assets are invested shall not affect their classification as investment, provided that such alteration does not contravene the laws of the country concerned.
(2) The term "returns" shall mean the amounts yielded by an investment in accordance with paragraph 1 for a definite period as profit, dividends, interest, licence or other fees.
(3) The term "investors" shall mean,
In respect to the Federal Republic of Germany:
Germans with a residence within the area of application of this treaty and any juridical person as well as any commercial or other company or association with or without legal personality having its seat in the area of application of this treaty and lawfully existing consistent with legal provisions, irrespective of whether the liability of its partners, associates or members is limited or unlimited and whether or not it operates for profit;
In respect to the People's Republic of Bulgaria:
Any juridical person as well as any economic company or other company or association with or without legal personality having its seat in the area of application of this treaty and which is registered, in so far as this is required under Bulgarian legislation, whether or not it operates for profit, that under the areas of this treaty make investments in the territory of the other contracting party.

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THEME 2
Admission and establishment

INTRODUCTION

This chapter analyses the provisions included in international investment agreements that regulate the entry and establishment of foreign investments within the territory of a host country. Depending on the desired scope of protection, IIAs may grant a right of admission or a right of establishment. These rights may be based on a variety of concepts and standards that are articulated in particular with issues concerning the avoidance of discrimination between foreign and domestic investors and/or investors from different home countries (national treatment and most-favoured-nation treatment).

At the end of this theme, students should be able to:

- Understand the significance of admission and establishment provisions;
- Identify and distinguish between pre- establishment and post-establishment models;
- Evaluate the nature of obligations created by a pre-establishment mode;
- Evaluate the nature of the obligation created by a post-establishment model;
- Analyze the policy implications of each model; and
- Draft a provision of admission and establishment.

HANDBOOK

1 Concept of admission and establishment

International customary law recognizes the right of States to control and limit the admission and establishment of foreign investors within their territories. Accordingly, the entry of a foreign investor has been considered a matter of domestic jurisdiction of the host State and a sovereign right of the State, This right can take the form of absolute restrictions or limits on foreign presence, or may involve discretionary authorization, registration and reporting requirements.

Box 50

Examples of measures that restrict or limit the entry of FDI

- **Absolute ban on all forms of FDI;**
- **Closing certain sectors to FDI;**
- **Quantitative restrictions on the number of foreign companies admitted in specific sectors;**
- **Application of certain legal form to investments;**
- **Compulsory joint ventures with public or private local investors;**
- **General screening/authorization of all investment proposals;**
- **Restrictions on certain forms of admission.**

However, the increasing pressures for more open economic policies and the worldwide competition for foreign investments have triggered important changes regarding the admission and establishment of foreign investments. By the inclusion of a clause embodying rights of entry and establishment for foreign investors, countries that seek to encourage FDI may have restricted their wide area of discretion both through unilateral liberalization of entry and establishment conditions in national laws and through international agreements.

Granting these rights is differentiated in two stages: the stage before the establishment of a presence in the host country (pre-establishment), and the stage following the establishment in the host country where the foreign investor engages in business activities (post-establishment).

Box 51

Right of admission and right of establishment

Right of admission deals with the entry and presence of foreigners in the territory of a host-country. It grants a permanent or temporary right to carry out business transactions in a host country, but does not necessarily include the right of establishing a permanent business presence.

Right of establishment deals with the rights of a foreign investor to establish a permanent business within the territory of a host country. This right is therefore narrower than the right of admission.

Typically, these rights are based on the principle of non-discrimination (national treatment and most-favoured-nation treatment, refer to Module 3, theme 3).

Box 52

National treatment and most-favoured-nation treatment

National treatment (NT) can be defined as a principle whereby a host country extends to foreign investors treatment that is at least as favourable as the treatment that it accords to national investors in like circumstances.

Most-favoured-nation treatment can be defined as a principle whereby a host country extends to foreign investors treatment that is at least as favourable as the treatment that it accords to other foreign investors in like circumstances.

Depending on the desired scope of protection, international investment treaties may grant a right of admission or a right of establishment. We may distinguish in this context between post- and pre-establishment approaches.

2 Post-establishment approach

The post-establishment approach is an application of the customary law principle that grants to the States the sovereign right to control and limit admission and establishment of foreign investments within their territories. It recognises the restrictions and controls on the admission of FDI stipulated by the laws and regulations of the host country. Accordingly, this model does not offer positive rights of entry and establishment, leaving the matter to national discretion. Host countries are allowed to develop specialized regimes to regulate particular types of FDI, to set specific conditions and to apply screening procedures. This ensures that the admission of foreign investments within the territory reflects national development policies of the host country.

Box 53

Types of regulatory measures and restrictions

- General conditions (development criteria, requirements related to national security, policy, customs, public moral, etc.);
- Conditions based on capital requirements;
- Other conditions (requirement for non-equity forms of investment, obtaining licenses, fees, performance requirements, etc.);
- Controls over ownership;
- Controls based on limitation of shareholder powers;
- Controls based on governmental intervention in the running of the investment;
- Other types of restrictions.

Under this approach national treatment is granted only after the establishment of a foreign investment within the territory of a host country. Consequently, IIAs do not accord positive rights of entry and establishment to foreign investors of the other contracting party. They expressly preserve the host State's discretion through a clause encouraging the contracting parties to promote favourable investment conditions between themselves but leaving the precise conditions of entry and establishment to the laws and regulations of each party.

Such approach is followed by most BITs signed by European countries (European model).

Box 54

Typical provision granting post-establishment rights: BIT Germany – Bulgaria, 1986

Article 2

1. Each contracting party shall in its territory promote, so far as possible, investment by investors of the other contracting party.

2. Each contracting party shall admit investments by investors of the other contracting party in accordance with its legislation.

3. Investments which are permitted in accordance with the legislation of either contracting party shall enjoy the protection of this treaty. Returns from the investment shall enjoy the same protection.

4. Each contracting party shall in any case accord investments by investors of the other contracting party fair and equitable treatment.

3 Pre-establishment approach

Pre-establishment rules provide clear and transparent provisions that increase predictability and reduce the degree of risk when entering a new market. Typically, they aim at avoiding discrimination between foreign and domestic investors and/or investors from different foreign countries. This model has its origins in the US BIT practice.

Box 55

Example of pre-establishment approach: USA BIT model, 2004

Article 4: Most-favoured-nation treatment

1. Each Party shall accord to investors of the other Party treatment no less favorable than that it accords, in like circumstances, to investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory.

Under this approach the host State limits its sovereign power regulating the entry of foreign investors and grants them full rights of admission and establishment based on whichever is better, national treatment or most-favoured-nation treatment. This is subject only to reserved list of sectors or activities to which such rights do not apply. The modalities adopted for these exceptions – reservations and commitments – can be broadly divided into two types: negative and positive lists.

Box 56

Negative and positive lists

Under the negative list approach, parties grant market access and national treatment for all sectors, listing particular exceptions – non-conforming measures. Accordingly, each party has the right to adopt or maintain exceptions only within the activities or matters listed.

Under the positive list approach, in contrast, parties include in commitments lists only those sectors where they have agreed to market access and national treatment.

The "positive list" approach may be more flexible than the "negative list" approach because it allows the host country not only to exclude sectors and activities in accordance with national development policies but also to maintain discriminatory measures in those sectors that are included in the commitments list.

The choice between these two approaches may depend on factors such as the size of the economy, the degree of liberalization or policies regarding foreign investments. Most BITs and investment chapters in Free Trade Agreements have opted for the "negative list" approach, reflecting the general openness of the economies of the treaty partners for FDI. The "positive list" approach has been adopted in services agreements (e.g. GATS and Montevideo Protocol of MERCOSUR), given their complexity and the diversity of the economic policies of the partners involved.

Box 57

Negative list provision: USA BIT model, 2004

Article 14: Non-Conforming Measures

1. Articles 3 [National Treatment], 4 [Most-favoured-Nation Treatment], 8 [Performance Requirements], and 9 [Senior Management and Boards of Directors] do not apply to:

(a) any existing non-conforming measure that is maintained by a party at:
the central level of government, as set out by that party in its Schedule to Annex I,
a regional level of government, as set out by that party in its Schedule to Annex I, or
a local level of government;

(b) the continuation or prompt renewal of any non-conforming measure referred to in subparagraph (a); or

(c) an amendment to any non-conforming measure referred to in subparagraph (a) to the extent that the amendment does not decrease the conformity of the measure, as it existed immediately before the amendment, with Articles 3 [National Treatment], 4 [Most-favoured-Nation Treatment], 8 [Performance Requirements], or 9 [Senior Management and Boards of Directors].

2. Articles 3 [National Treatment], 4 [Most-favoured-Nation Treatment], 8 [Performance Requirements], and 9 [Senior Management and Boards of Directors] do not apply to any measure that a party adopts or maintains with respect to sectors, subsectors, or activities, as set out in its Schedule to Annex II.

3. Neither party may, under any measure adopted after the date of entry into force of this treaty and covered by its Schedule to Annex II, require an investor of the other party, by reason of its nationality, to sell or otherwise dispose of an investment existing at the time the measure becomes effective. (...).

Exercises and questions for discussion

1. What is the difference between admission and establishment of a foreign investor?
2. What is the difference between the pre-establishment and post-establishment model?
3. Think of examples of cases in which the pre-establishment or the post-establishment model would be appropriate in an IIA.
4. Draft a provision on admission and establishment and explain it.

5. **Practical exercise**

   State A is a developed country in favor of liberalization. It follows a national treatment and most-favoured-nation treatment policy. State B is a developing country and is a member of a regional economic integration organization.State A is negotiating a BIT with State B. State A wants to include in the agreement pre-entry national treatment which would include the right of entry and establishment. However, State B wants to protect its natural resources and its social sector.

   As counselor for State B, draft the clause concerning the admission of investments.

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Theme 3
Standards of treatment

INTRODUCTION

Worldwide competition for foreign investments has increased the necessity to include standards of treatment that provide protection against discriminatory measures, both in national laws and in IIAs. The most common standards embodied in IIAs are national treatment, most-favoured-nation treatment and fair and equitable treatment.

At the end of this theme, students should be able to:

- Understand the significance of treatment provisions;
- Identify and distinguish between various types of treatment;
- Analyze the implications of treatment provisions;
- Evaluate the nature of the obligations created by treatment provisions; and
- Draft treatment provisions.

HANDBOOK

1 Standards of treatment

In the context of IIAs the term "treatment" refers to the legal regime that applies to investors and their investments. International law does not require host countries to grant them a higher standard of treatment than the generally recognised "minimum standard of treatment".

However, worldwide competition for foreign investments has resulted in the inclusion – both in national laws and in IIAs – of standards of treatment that provide protection against discrimination. The most common standards embodied in IIAs are national treatment, most-favoured-nation treatment and fair and equitable treatment.

National treatment and most-favoured-nation treatment are known as contingent and relative standards.

Box 58

Contingent and relative standards

Contingent: the standard defines the contents of the treatment by reference to an existing national regime in the host country. As national regimes change over time, the content of the standard may also change.

Relative: the standard invites a comparison in the treatment accorded to foreign and domestic investors/other foreign investors. This makes a determination of its content dependent on the treatment offered by a host country to domestic investors/other foreign investors and not on some *a priori* absolute principle of treatment.

In contrast, fair and equitable treatment is known as an **absolute standard** because it defines *a priori* the standard of treatment without reference to other legal systems or other standards of treatment.

2 National treatment

2.1 Definition and content of the standard

National treatment can be defined as a principle whereby a host country extends to foreign investors treatment that is at least as favourable as the treatment that national investors in like circumstances receive.

It seeks to ensure a degree of competitive equality between national and foreign investors and serves to eliminate distortions in competition resulting from discriminatory legal regimes or administrative practices.

IIAs have defined the standard of national treatment in two main ways. One way requires a strict standard of equality of treatment between national and foreign investors. The other offers the possibility of granting more favourable treatment to foreign investors.

- **Strict standard: "same" or "as favourable as" treatment.** This formulation suggests that the treatment offered to foreign investors is no better than that received by national investors. In effect it excludes the possibility of the foreign investor claiming preferential treatment as a matter of treaty obligation on the part of the host country. However, there is nothing in this formulation to prevent a host country from treating foreign investors in a preferential way, should it so choose. National investors may challenge such preferential treatment. They may have rights under the host country law to challenge such treatment, for example, under national constitutional provisions against discrimination.

  In addition, the provision might be incorporated into national laws. This may have the effect of extending protection to national investors as well, although much depends on the actual wording of the agreement and the extent to which national laws give rights to domestic investors in such cases.

Box 59

Example of national treatment: BIT United Kingdom – Belize, 1982

Article 3: National treatment and most-favoured-nation provisions
1. Neither contracting party shall in its territory subject investments or returns of nationals or companies of the other contracting party to treatment less favourable than that which it accords in the same circumstances to investments or returns of its own nationals or companies or to investments or returns of nationals of any third State.

- **Flexible standard: "No less favourable" treatment.** This formulation is the most commonly used in IIAs. It leaves open the possibility that foreign investors receive better treatment than the host country's own nationals.

Box 60

Example of national treatment: BIT China – Germany, 2003

Article 3: National treatment and most-favoured-nation provisions
1. Neither contracting party shall in its territory subject investments or returns of nationals or companies of the other contracting party to treatment less favourable than that which it accords in the same circumstances to investments or returns of its own nationals or companies or to investments or returns of nationals of any third State.

As to the **content of the standard**, some IIAs qualify the definition of the national treatment standard by specifying the factual situations in which the standard applies. The following alternatives may present themselves:

- **"Same" or "identical" circumstance.** The most restrictive formulation is to limit national treatment to the "same" or "identical" circumstances. This offers a narrow scope to national treatment as the incidence of an "identical" situation may be hard to show.

Box 61

Example: BIT United Kingdom – Belize, 1982

Article 3: National treatment and most-favoured-nation provisions
1. Neither contracting party shall in its territory subject investments or returns of nationals or companies of the other contracting party to treatment less favourable than that which it accords in the same circumstances to investments or returns of its own nationals or companies or to investments or returns of nationals of any third State.

- **"Like situations", "similar situations" or "like circumstances".** Qualifications such as "like situations," "similar situations" and "like circumstances" can be seen as synonymous and therefore can be discussed together. They may be less restrictive of national treatment in that they may apply to any activity or sector that is not subject to exceptions. What is a "like" situation or circumstance is a matter that needs to be determined in the light of the facts of the case. This assumes that clear comparisons of business situations are possible. It is implicit in the use of this term that the host country will assess cases in good faith and in full consideration of all relevant facts.

Box 62

Example: USA BIT model, 2004

Article 4: Most-favoured nation treatment
1. Each party shall accord to investors of the other party treatment no less favorable than that it accords, in like circumstances, to investors of any non-party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory.

- **No factual comparisons.** A significant number of IIAs contain a description of the national treatment standard but are silent on whether national treatment applies to specified activities or like situations or circumstances. Here a simple reference is made to investors and/or investments, usually in separate paragraphs, followed by a description of the standard of treatment required. This approach offers the widest scope for comparison as, in principle, any matter that is relevant to determining whether the foreign investor is being given national treatment can be considered. The test will be an easier one for the investor than under formulations requiring proof of like situations, circumstances and/or functional contexts.

Box 63

Example: BIT China – Germany, 2003

Article 3 Treatment of investment
2. Each contracting party shall accord to investments and activities associated with such investments by the investors of the other Contracting Party treatment not less favourable than that accorded to the investments and associated activities by its own investors.

2.2 Scope of application

The question of the scope of application of the national treatment standard involves two separate issues:

(a) **The application of the standard depending on the stage of the investment process:** At what stage of the investment process (the entry and establishment phases) does national treatment apply?

The standard may apply:

- To all phases of an investment: it applies to both the pre- and post-entry stages of the investment process (**pre-establishment approach**);

- Only to the treatment of foreign investment after its entry: it applies only to investments after their admission to a host country (**post-establishment approach)**.

Initially, the standard was thought not to be pertinent to entry issues, on the grounds that countries have a sovereign right, well established in international law, to control the entry of foreigners. In addition, a foreign investor, "outside" the host country, was not seen in a similar or comparable position to the domestic investor, and as such national treatment made little sense. The extension of national treatment to the pre-entry phase, in the recent US and Canadian BITs and the North American Free Trade Agreement, may begin to change the approach to this issue (Refer to Module 3, theme 2).

(b) **The application of the standard to subnational levels:** What is the meaning of national treatment where States have subnational authorities exercising constitutional powers to make investment policy?

It is clear that a treaty applies to the entire territory of a party unless a different intention appears in the treaty or is otherwise established. However, it is not always so clear in practice what national treatment means in relation to the political subdivisions of a State. This problem (which is also relevant to other clauses in IIAs) can become significant where a subnational authority has a constitutional power to make investment policy. Such power may be used to grant preferential treatment to local, as opposed to foreign investors, for example, where a host subnational authority is seeking to encourage the growth of local small and medium-sized firms. A question that arises is whether a subnational authority has to extend such preferential treatment to foreign inward investors on the basis of the national treatment standard, regardless of how it treats national investors outside the subnational level. The question has been answered in the provisions of some IIAs, such as US BITs.

Box 64

Example: USA BIT model, 2004

Article 3: National treatment

3. The treatment to be accorded by a party under paragraphs 1 and 2 means, with respect to a regional level of government, treatment no less favorable than the treatment accorded, in like circumstances, by that regional level of government to natural persons resident in and enterprises constituted under the laws of other regional levels of government of the party of which it forms a part, and to their respective investments.

According to this provision, it appears that a foreign investor is to be treated by a US subnational authority as if it were an investor from another US subnational authority for the purpose of compliance with national treatment disciplines. Thus, if the host subnational State offers preferential treatment to local investors and does not extend such treatment to out-of-State investors, the foreign investor cannot invoke national treatment to obtain similar preferences. All that the foreign investor can do is require treatment no less favourable than that accorded to out-of-State US investors. Although the US model is ambiguous on the issue, it may be presumed that the comparable treatment should be with the best-treated out-of-State US investor; otherwise the treatment would be "less favourable".

Further issues arise in relation to non-governmental self-regulatory organizations that undertake regulatory functions in many industries. Should such bodies be subject to national treatment disciplines and, if so, how? This question has not yet been resolved.

2.3 Exceptions to national treatment

The use of exceptions enables host countries to exclude certain types of enterprises, activities or industries from the operation of national treatment. The number and scope of exceptions determines the practical effect of national treatment under an investment agreement.

Box 65

Types of exception to national treatment

General exceptions based on reasons of public health, order and morals, and national security – such exceptions are present in most regional and multilateral investment agreements, and also in a number of BITs.

Subject-specific exceptions which exempt specific issues from national treatment, such as intellectual property, taxation provisions in bilateral tax treaties, prudential measures in financial services or temporary macroeconomic safeguards.

Country-specific exceptions whereby a contracting party reserves the right to differentiate between domestic and foreign investors under its laws and regulations – in particular, those related to specific industries or activities – for reasons of national economic and social policy, country-specific exceptions may overlap with subject-specific exceptions.

3 Most-favoured-nation treatment

3.1 Definition and content of the standard

As stated earlier, most-favoured-nation treatment can be defined as a principle whereby a host country extends to foreign investors treatment that is at least as favourable as the treatment that it accords to investors from another foreign country in like circumstances. MFN is a core element of IIAs. MFN treatment potentially applies to all kinds of investment activities, such as the operation, maintenance, use, sale or liquidation of an investment, and can be invoked with regard to any investment-related legislation.

Most agreements define MFN as "treatment no less favourable" than that accorded to nationals of third countries and additionally include that such treatment only applies "in like circumstances". MFN covers discrimination based on law (*de iure* discrimination), and discrimination caused by other measures (*de facto* discrimination).

Many IIAs entitle both foreign investors and their investments to MFN. There are, however, agreements that grant MFN only to the investment (e.g. the 1994 Energy Charter Treaty) or only to the investor with regard to its investment (e.g. the French model BIT), thereby narrowing the scope of the MFN clause. However, despite the use of different terminology, the basic thrust of MFN, namely its non-discriminating character among foreign investors investing in a particular host country, remains unchanged.

The MFN clause only covers general treatment usually provided to investors from a given foreign country. Special privileges or incentives granted to an individual investor (so-called "one-off" deals) do not create an obligation under the MFN clause. Only if individual treatment becomes general practice, could the MFN provision apply.

Different treatment of foreign investors from different countries is justified if the investors are in different objective situations. Hence, different treatment in, for example, different sectors of economic activity would still be possible, unless the only purpose of the differentiation were to exclude investors of a particular nationality.

As to the types of MFN clauses in IIAs, they are usually reciprocal (as opposed to unilateral), meaning that all contracting parties are bound by it, unconditional and unlimited, and they apply to all investment-related matters.

By including an MFN clause in an IIA, the treaty parties commit themselves to preventing discrimination against investors from foreign countries on grounds of their nationality. Consequently, it limits a country's room for manoeuvre with respect to future agreements, as they might cause a so-called "free rider" situation. However, it should be noted that the MFN clause works both ways, e.g. it may create additional obligations, but can also create additional rights for treaty partners.

Box 66

Example of a "free rider" situation

Countries X and Y have concluded a BIT containing an MFN clause. Some years later, country X concludes another BIT with country Z, granting Z certain rights that it did not grant to Y. By invoking the MFN clause in the BIT between X and Y, country Y can now claim the additional rights granted to Z. As a consequence, the original contractual balance between X and Y is upset, since the MFN clause has added further obligations upon X without imposing any obligations upon Y.

Initially, certain countries construed the MFN clause as a "conditional" one, implying an obligation on the benefiting country to renegotiate the original agreement, in order to re-establish the contractual balance. This approach raised the objection that it deprived the MFN clause of its automatic effect and so rendered it ineffective. By the 1920s, this view prevailed and an unconditional approach to MFN was adopted, whereby all parties to the agreement assent to apply MFN regardless of whether or not this results in fully reciprocal obligations. The dimension of the "free rider" problem depends on the extent to which it creates asymmetrical situations. Thus, it may be less acceptable in the case of regional or multilateral agreements than in bilateral ones due to the potentially great number of "free riders" involved.

Box 67

Example of most-favoured-nation treatment: USA BIT model, 2004

Article 4: Most-favoured nation treatment

1. Each party shall accord to investors of the other party treatment no less favorable than that it accords, in like circumstances, to investors of any non-party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory.

2. Each party shall accord to covered investments treatment no less favorable than that it accords, in like circumstances, to investments in its territory of investors of any non-party with respect to the

Box 67

Example of most-favoured-nation treatment: USA BIT model, 2004

establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

3.2 Scope of application

MFN clauses can either apply at the post-entry stage (post-establishment model) or apply also at the pre-entry stage (pre-establishment model) (see also Module 3 theme 2).

Post-establishment model. The majority of BITs do not contain obligations concerning the admission of foreign investment. MFN is to be applied only after an investment has been made.

Pre-establishment model. This second model requires the application of the MFN standard in respect of both establishment and subsequent treatment of investment. The approach is followed by, for example, most BITs of the US, and some recent treaties made by Canada.

3.3 Exceptions

As the scope of the MFN standard is very broad, it could apply to domains such as social and labour matters, taxation or environmental protection. These policy areas are usually governed by reciprocity rules, stipulated for example in bilateral tax treaties or agreements on the protection of environment or intellectual property rights. In these rather sensitive areas, an unqualified commitment to MFN would lead to an extension of rights towards a third party without any reciprocity commitment from their side. To avoid unfavourable consequences, IIAs may comprise different types of exceptions to the MFN standard. They can be classified as:

- General exceptions;
- Reciprocal subject-specific exceptions;
- Country-specific exceptions.

3.3.1 General exceptions

General exceptions are, as the term says, of a general nature and not specifically limited to MFN. The most important general exceptions are those relating to public order, health and morality and national security (although most BITs do not contain an exception for national security reasons, as opposed to several pluri- and multilateral agreements).

3.3.2 Reciprocal subject-specific exceptions

Many IIAs comprise exceptions specifically addressing the MFN clause and based on reciprocity. The most frequent exceptions refer to taxation, intellectual property, regional economic integration organizations, mutual recognition, and other bilateral issues.

Box 68

Reciprocal subject specific exceptions

1. Taxation: An MFN exception means in this case that a contracting party is not obliged to extend to its treaty partners, via the MFN clause, any advantage granted to a third country and its investors under a bilateral agreement on the avoidance of double taxation.

2. REIO clause: IIAs often contain a REIO clause which exempts members of a regional economic integration organization from the obligation to grant MFN to non-members. The REIO clause allows members of a REIO to advance with their internal investment liberalization at a faster pace than that to which non-members have agreed in separate agreements.

Example: BIT China – Germany, 2003
Article 3: Treatment of Investment
(4) The provisions of Paragraphs 1 to 3 of this Article shall not be construed so as to oblige one Contracting Party to extend to the investors of the other Contracting Party the benefit of any treatment, preference or privilege by virtue of

(a) any membership or association with any existing or future customs union, free trade zone, economic union, common market;
(b) any double taxation agreement or other agreement regarding matters of taxation.

3. Intellectual property: Most BITs apply the MFN clause fully with regard to intellectual property. However, where IIAs contain obligations for the post-establishment phase, the MFN commitment only applies once the rights have been granted. This allows the host country to condition the acquisition of an intellectual property right on the fulfilment of certain requirements.

Box 68

Reciprocal subject specific exceptions

4. Mutual recognition: Mutual recognition agreements serve to facilitate the cross-border provision of services. Through these agreements, States recognize the legal requirements of their partner country with regard to particular services, e.g. professional services or financial services, as equivalent to their own domestic requirements. Consequently, foreign investors can offer their services without having to obtain domestic licenses or permits. An unlimited MFN would imply that a State is obliged also to recognize regulations relating to services in third countries, although a recognition agreement does not exist in this respect and, accordingly, the commitment is not reciprocal.

5. Other bilateral issues: other investment-related issues that are based on the concept of reciprocity and usually addressed only on a bilateral basis are also not apt for a multilateralization via an MFN clause. (Examples: bilateral transportation agreements, fishing arrangements). IIAs have not yet explicitly dealt with these issues. However, in the context of the OECD MAI negotiations, the possible need for exceptions in this respect has been discussed.

3.3.3 Country-specific exceptions

Some treaties (e.g. GATS, NAFTA) allow for the scheduling of exceptions to MFN treatment concerning any measure, sector or activity, provided that the exception is listed in a country-specific schedule.

Box 69

Example of fair and equitable treatment: BIT China – Germany, 2003

Article 3: Treatment of investment
1. Investments of investors of each contracting party shall at all times be accorded fair and equitable treatment in the territory of the other contracting party.

4 Fair and equitable treatment

Together with the national treatment and most-favoured-nation treatment standards, the fair and equitable treatment standard provides a useful yardstick for assessing relations between foreign direct investors and governments of capital-importing countries.

As a general proposition, the standard also acts as a signal from capital-importing countries: if a host country provides an assurance of fair and equitable treatment, it presumably wishes to indicate to the international community that investment within its jurisdiction will be subject to treatment compatible with some of the main expectations of foreign investors.

Box 70

Fair and equitable treatment as a single standard

In most treaties and other instruments that provide for fair and equitable treatment for investments, the words "fair" and "equitable" are combined in the form of a reference to "fair and equitable treatment". This approach suggests that there is, in fact, a single standard, the fair and equitable standard, as distinct from two separate standards, one concerning fairness, and the other equity. Certain considerations support this perspective:

- First, the consistency with which States have linked the two terms "fair and equitable" treatment may be interpreted in such a way that these States believe there is one standard.
- Second, if States wished to indicate that "fair and equitable" treatment actually referred to two separate standards, this option would be open to them. They could, for instance, set out the fairness standard in one treaty provision, and the equity standard in another; arguably, they have not done so precisely because they believe the phrase "fair and equitable treatment" denotes a single standard.

In some cases, however, treaties and other investment instruments contain references not to "fair and equitable" treatment, but to "equitable" treatment only.

At least two different views have been used with regard to the precise meaning of the term "fair and equitable treatment" in investment relations:

- Plain meaning approach;
- Equating fair and equitable treatment with the international minimum standard.

4.1 The planning approach

In this approach, the term "fair and equitable treatment" is given its plain meaning: hence, where a foreign investor has an assurance of treatment under this standard, a straightforward assessment needs to be made as to whether a particular treatment meted out to that investor is both "fair" and "equitable".

The plain meaning approach is consistent with accepted rules of interpretation in international law. Also, because it appears that there is no judicial decision on the precise meaning of the fair and equitable standard in particular situations, it seems that States are in agreement on the meaning of the term.

However, the plain meaning approach is not without its difficulties:

- The concepts "fair" and "equitable" are by themselves inherently subjective, and therefore lacking in precision.
- Difficulties of interpretation may also arise from the fact that the concepts, "fair and equitable treatment", in their plain meaning, do not refer to an established body of law or to existing legal precedents. This is problematic because, with no particular agreement as to the content of the term, the plain meaning approach could give rise to conflicting interpretations in practice.
- The question may arise on how the "fair and equitable" standard relates to the principle of non-discrimination, i.e. to identify situations of unfair and non-equitable treatment without any discrimination being involved.

4.2 International minimum standard

The second approach to the meaning of the concept suggests that fair and equitable treatment is synonymous with the international minimum standard in international law. This interpretation comes from the assumption that, under customary international law, foreign investors are entitled to a certain level of treatment, and that treatment which falls short of this level gives rise to liability on the part of the State. If, in fact, fair and equitable treatment is the same as the international minimum standard, then some of the difficulties of interpretation inherent in the plain meaning approach may be overcome, as there is a substantial body of jurisprudence and doctrine concerning the elements of the international minimum standard.

However, an approach at the policy level that equates fair and equitable treatment with the international minimum standard is problematic in certain respects:

- If States and investors believe that the fair and equitable standard is entirely interchangeable with the international minimum standard, they could indicate this clearly in their investment instruments; but most investment instruments do not make an explicit link between the two standards. Therefore, it cannot readily be presumed that most States and investors believe fair and equitable treatment is implicitly the same as the international minimum standard.
- Attempts to equate the two standards may be perceived as paying insufficient regard to the substantial debate in international law concerning the international minimum standard. More specifically, while the international minimum standard has strong support among developed countries, a number of developing countries have traditionally held reservations as to whether this standard is a part of customary international law.

Exercises and questions for discussion

1. What are the major policy approaches regarding the national treatment provision?
2. What may be the rationale for excluding the NT provision from a BIT?
3. Imagine that country A gives a subsidy to a particular domestic investor in an investment contract, because it considers this investment as especially important. Could a foreign investor claim the same treatment under the NT provision?
4. Name the three types of exceptions to an MFN clause that IIAs might contain.
5. Explain the so-called "free rider" issue and list some of the features that characterize it.
6. Think of an example where a country would have an interest to take an exception to MFN treatment in an IIA.
7. What does the following affirmation mean: "fair and equitable treatment is a contingent standard"?
8. Briefly explain the difference between the "plain meaning" approach to the fair and equitable standard, and the approach that equates this standard to the "international minimum standard".
9. Taking into account your country policies regarding investment, draft a definition of treatment.
10. Think of an example where a foreign investor is treated in an unfair manner.

Exercises and questions for discussion

11. Practical exercises

National Treatment

State A is a developed country in favour of liberalization. It follows a comprehensive national treatment and most-favoured-nation treatment policy. State B is a developing country that wants to attract FDI and wants to grant NT to as wide a range of situations as possible once the investment has been admitted on the territory of the host country. As counselor for State B, draft the clause on national treatment to be discussed with State A.

Most-Favoured-Nation Treatment

Look at the text of the following two examples of MFN provisions and explain their main differences:

Energy Charter Treaty (1994), Article 10(7):
Each contracting party shall accord to Investments in its Area of Investors of other contracting parties, and their related activities including management, maintenance, use, enjoyment or disposal, treatment no less favourable than that which it accords to Investments of its own Investors or of the Investors of any other contracting party or any third State and their related activities including management, maintenance, use, enjoyment or disposal, whichever is the most favourable.

North American Free Trade Agreement (1992), Article 1103:
(1) Each party shall accord to investors of another party treatment no less favorable than that it accords, in like circumstances, to investors of any other party or of a non-party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.
(2) Each party shall accord to investments of investors of another party treatment no less favorable than that it accords, in like circumstances, to investments of investors of any other party or of a non-party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

Fair and Equitable Treatment

Country A, a capital-exporting country, is negotiating a BIT with country B, a capital-importing country. You are the representative of country B. You are requested by your Minister of Trade to draft the fair and equitable treatment provision taking into account that the country seeks to attract FDI to its territory, but wishes nevertheless to assure for its domestic investors and investments, at least the same level of protection which is granted to foreign investors and investments.

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THEME 4
Protection

INTRODUCTION

Legal protection of investments in the host country is a key issue for foreign investors. From the perspective of a foreign investor, an investment can hardly be considered protected unless the host country has committed itself to protecting his/her properties and to permitting the payment, conversion and repatriation of amounts relating to the investment in question. Another important issue is possible discrimination (refer to Module 3, theme 3). The risk assessments that a foreign investor makes at the time of entry may not be accurate since internal policies relating to foreign investment are subject to change, as are the political and economic conditions in a host country. These shortcomings can be addressed by additional protection at the international level as required.

At the end of this theme, students should be able to:

- Distinguish between different categories of takings;
- Identify different approaches of what amounts to a taking;
- Characterize the conditions for a lawful taking;
- Identify different standards of compensation;
- Identify the scope of the transfer provision and possible exceptions;
- Distinguish between different types of transfers;
- Identify different approaches as to how to deal with transfers set forth in different types of agreements;
- Analyze economic and development implications of various types of provisions; and
- Analyze possible implications and policy options of various types of provisions

HANDBOOK

1 Taking of property

The taking of property by a host country has constituted one of the most important risks to foreign investment. As a foreign investor operates within the territory of a host country, the investor and its property are subject to the legislative and administrative control of the host country.

The taking of property by governments can result from legislative or administrative acts that transfer title and physical possession. Takings can also result from official acts that effectuate the loss of management, use or control, or a significant depreciation in the value, of assets. Generally speaking, the former can be classified as "direct takings" and the latter as "indirect takings".

Box 71

Categories of takings

Direct takings are associated with measures that have given rise to the classical category of takings under international law. They include the outright takings of all foreign property in all economic sectors, takings on an industry-specific basis, or takings that are firm-specific. Usually, outright takings in all economic sectors or on an industry-specific basis on political grounds have been labeled "nationalizations". Firm-specific takings, on the other hand, have often been called "expropriations". Both nationalizations and expropriations involve the physical taking of property.

Indirect takings are some measures that may amount to takings in that they result in the effective loss of management, use or control, or a significant depreciation of the value, of the assets of a foreign investor. Some particular types of such takings have been called "creeping expropriations", while others may be termed "regulatory takings".

A taking is lawful provided it satisfies certain conditions. To begin with, special limitations on a State's right to take property may be imposed by treaty. In customary international law, there is authority for a number of limitations or conditions that relate to:

- The requirement of a public purpose for the taking;
- The requirement that there should be no discrimination;
- The requirement that the taking should be accompanied by payment of compensation;
- The requirement of due process.

Public purpose. The term "public purpose" has a relatively wide scope. Usually, a host country's determination of what is in its public interest is accepted. There is some indication that, where a taking is by way of reprisal against the act of a home State of a foreign national, it is considered illegal on the grounds that it lacks public interest.

Non-discrimination. The non-discrimination requirement demands that governmental measures, procedures and practices be non-discriminatory even in the treatment of members of the same group of aliens. In fact, any taking that is pursuant to discriminatory or arbitrary action, or any action that is without legitimate justification, is considered to be contrary to the non-discrimination requirement, even absent any singling-out on the basis of nationality. This includes prohibition of discrimination with regard to due process and payment of compensation requirements (see below).

Compensation. The issue that is most likely to raise a dispute in the taking of foreign property is the standard of compensation that is payable to a foreign investor.

Box 72

Standards of compensation

Hull standard: This standard requires the payment of full market value as compensation, without delay and in convertible currency: "prompt, adequate and effective compensation".

Appropriate compensation standard: This standard contemplates that equitable principle should be the guide in the matter of assessing compensation rather than the pure market value of the investment. This is a vague standard, but the idea is that inability to pay immediate and full compensation should not deter a State, which decides that it is necessary to take foreign property in the interest of economic development, from doing so.

Book-value method of valuation: This may consist of either the net book value (depreciated assets value) or the updated book value, also referred to as the adjusted book value, taking inflation into account. Alternatively, the tax value of the assets can be referred to.

More generally, each of the competing formulas of compensation may lead to different outcomes: the "Hull formula" suggests a "fuller", more satisfactory to the investor type of compensation, while the "appropriate compensation" formula suggests that additional concrete (historical or other) considerations may be taken into account which could result in a lower final payment.

The due process requirement. There is some uncertainty as to the interpretation of the term "due process" in international law. It usually requires that the compensation of a foreign investor should be assessed by an independent host country tribunal. Such a provision is now found in the takings provisions of many bilateral and some regional agreements. This requirement is usually satisfied by the legislation affecting the taking which will provide the mechanism for the assessment of the compensation. Thus, due process may be met by other kinds of regular administrative procedures than court proceedings.

Box 73

Examples of definition of taking

Finland BIT model, 2001
Article 5(1): Expropriation
Investments by investors of a contracting party in the territory of the other contracting party shall not be expropriated, nationalised or subjected to any other measures, direct or indirect, having an effect equivalent to expropriation or nationalisation (hereinafter referred to as "expropriation"), except for a purpose which is in the public interest, on a non-discriminatory basis, in accordance with due process of law, and against prompt, adequate and effective compensation.

BIT Sweden – Argentina, 1991
Article 4:
Neither of the contracting parties shall take any direct or indirect measure of nationalization or expropriation or any other measure having the same nature or the same effect (...)

World Bank Guidelines on the Treatment of Foreign Direct Investment, 1992
Article 4(1):
A State may not expropriate or otherwise take in whole or in part a foreign private investment in its territory, or take measures which have similar effects, except where this is done in accordance with applicable legal procedures, in pursuance in good faith of a public purpose, without discrimination on the basis of nationality and against the payment of appropriate compensation.

2 Transfer of funds

The primary purpose of a transfer provision in an IIA is to set forth a host country's obligation to permit the payment, conversion and repatriation of the funds that relate to an investment. This includes, for instance, the initial capital for making the investment, the repatriation of profits, compensation payments by the host country and capital resulting from the dissolution or termination of the investment.

In light of the importance of transfer obligations to foreign investors, a country wishing to attract investment stands therefore to benefit from the inclusion of a comprehensive and sufficiently detailed transfer provision. But a host country may also seek qualifications, the most important of which relates perhaps to the ability of the country to impose restrictions on transfers in response to a balance-of-payments crisis.

The key issues that arise in the design of a transfer provision can be divided into two categories. The first category relates to the scope of the general obligation undertaken by the host country; this category includes issues relating to the types of transfers that are covered by the transfer provision and the nature of the obligation that applies to these transfers. The second category relates to the principal exceptions and qualifications to this general obligation, the most important of which relate to a derogation for economic reasons.

2.1 Scope of the general obligation

The types of transfers protected under an agreement largely depend on the type of investments covered and the nature of the obligations that apply to these investments. With respect to the different types of investments, if an agreement only covers **inward investment** (i.e. investment made in the host country by investors of foreign countries), the transfers covered typically include funds that are needed to make the initial investment by the foreign investor and the proceeds of any such investments, including profits and the proceeds of any sale or transfer.

However, if an agreement also covers outward investment (i.e. investment made in other countries by nationals or residents of the home country), it typically also covers funds needed by such nationals to make an **outward investment**. The requirement to allow for outward transfers by both foreign investors and the country's own investors (which are provided for in some multilateral agreements) can have important foreign exchange implications for the host country.

The obligation that applies to transfers is normally of an absolute rather than relative nature. This distinguishes it from the national treatment obligation that normally applies to the admission and treatment of investment. Specifically, while the latter obligation ensures that foreign investors are treated no less favourably than a host country's own nationals, the transfer obligation may actually provide the foreign investor with preferential treatment, as is the case with other investment protection obligations (e.g. expropriation). With respect to the various elements of the obligation, the transfer obligation requires the elimination of restrictions not only on the ability of an investor to receive and repatriate amounts relating to investments, but also on the ability of the investor to convert the currency prior to repatriation. Key issues in this area relate to the type of foreign currency that the investor is entitled to convert into and the applicable rate of exchange.

Box 74

Examples of transfer of funds provisions

BIT United Kingdom – Ghana, 1989

Article 8, Repatriation of Investment and Returns

Each contracting party shall, in respect of investments, guarantee to nationals or companies of the other contracting party the unrestricted transfer to the country where they reside of their investments and returns. Transfers of currency shall be affected without undue delay in the convertible currency in which the capital was originally invested or in any other convertible currency agreed by the investor and the contracting party concerned. Unless otherwise agreed by the investor, transfers shall be made at the rate of exchange applicable on the date of transfer pursuant to the exchange regulations in force.

BIT Croatia – Canada, 2001

Article IX, Transfer of Funds

2. Transfers shall be affected without delay in the convertible currency in which the capital was originally invested or in any other convertible currency agreed by the investor and the contracting party concerned. Unless otherwise agreed by the investor, transfers shall be made at the rate of exchange applicable on the date of transfer.

BIT Malaysia – Indonesia, 1994

Article VI, Repatriation of Investment

2. To the extent the investor of either contracting party has not made another arrangement with the appropriate authorities of the other contracting party in whose territory the investment is situated, currency transfer made pursuant to paragraph 1 of this Article shall be permitted in the currency of the original investment or any other freely usable currency.

3. The exchange rates applicable to such transfer in paragraph 1 of this Article shall be the rare exchange prevailing at the time of remittance.

2.2 Exceptions

Perhaps the most critical issue that arises in the design of a transfer provision in IIAs is whether or not a qualification to the general obligation described above needs to be made that effectively excuses the host country from performing its obligations on the basis of its economic circumstances.

While multilateral agreements generally provide for such derogation, most regional and bilateral agreements do not, out of a concern that these qualifications would undermine the principle of investor protection, which is the overriding objective of most of these agreements.

The principal economic derogation provisions can be divided into two categories:

- The first sets forth the conditions under which a host country can impose new restrictions on a temporary basis for reasons relating to balance of payments and macroeco-

nomic management – **temporary economic derogation**.
- The second category permits the host country to maintain existing restrictions that would otherwise not be permitted, on the grounds that the economy of the host country is not yet in a position to eliminate these restrictions – **transitional provisions**.

Box 75

Exceptions, temporary derogation, transitional provisions

Temporary derogation
In circumstances in which a country that has eliminated restrictions on a broad range of investments is confronted with balance of payments problems, restrictions on transfers can play a constructive role in the resolution of these crises. However, given the limited, but important role that restrictions on transfers may play, care must be taken to ensure that any temporary derogation provision carefully circumscribes the conditions under which new restrictions may be imposed. Most derogation provisions contain some mechanism to ensure that the restrictions are of a **temporary basis** and also require that restrictions be of a **non-discriminatory** nature.

Transitional provisions
Multilateral agreements also contain provisions that allow a host country to maintain restrictions that are in place upon its accession to an agreement. These provisions are normally designed to address situations in which a host country's economy may not yet be prepared for full liberalization in certain sectors and where it is perceived that the continued maintenance of restrictions may, in fact, contribute to macroeconomic and balance of payments stability. In light of the purpose of these provisions, one critical question is whether the protection provided by such provisions should, in fact, be transitional. In other words, should a country be required to phase out these restrictions once the economic weaknesses that justified them disappear?

Box 76

Examples of exception provisions

BIT Netherlands – United States, 1998
Article 4, Transfers
2. Notwithstanding paragraph (1) above, a contracting party may delay or prevent a transfer through the equitable, non-discriminatory and good faith application of measures:
- to protect the rights of creditors,
- relating to or ensuring compliance with the laws and regulations:
  on the issuing, trading and dealing in securities, futures and derivatives,
  concerning reports or records of transfers, or
- in connection with criminal offences and orders or judgments in administrative and adjudicatory proceedings.

However, such measures and their application shall not be used as a means of avoiding the contracting party's commitments or obligations under the agreement.

BIT Australia – China, 1988
Article X
3. Either contracting party may protect the rights of creditors, or ensure the satisfaction of judgements in adjudicatory proceedings, through the equitable, non-discriminatory and good faith application of its law.

Exercises and questions for discussion

1. What are the different types of takings, and what are their characteristics?
2. Explain the meaning of the term "creeping expropriation" and give an example.
3. Cite and explain the requirements of a taking to be legal under international law.
4. Cite and explain the different standards of compensation and their policy implications.
5. What kinds of transactions are covered by the transfer of funds provision?
6. Name the two possible types of derogation provisions that could be introduced into a transfer clause.
7. Indicate the conditions that restrictions to the free transfer of funds have to fulfil.
8. Discuss the pros and cons of a transfer restriction from the viewpoint of the host country.

Exercises and questions for discussion

9. Practical exercises

Taking of Property

Indicate which category of takings where the following examples belong to:

Example \ Category	Nationalization	Expropriation (specific taking)	Creeping expropriation	Regulatory measure
Country A passes a Banking Regulation Act ordering the taking of 12 private banks partly owned and managed by foreign investors. The taking is said to be inevitable for economic reasons.				
Country B passes a law prohibiting the import and the production of certain chemical substances for environmental and health reasons. Company X, owned by a foreign investor, uses these substances in its production of goods.				
Country C takes 1500 square metres of land from the foreign investor Y to build a new track for the national railway.				
Country D passes a law determining that each company of a certain size that is owned by non-nationals must have one or more representatives appointed by the Government to its board of management.				

Look at the following provisions, describe and compare critically the standards of compensation that each provision provides:

North American Free Trade Agreement (1992), Article 1110

(1) No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:

- for a public purpose;
- on a non-discriminatory basis;
- in accordance with due process of law and Article 1105(1); and
- on payment of compensation in accordance with paragraphs 2 through 6.

(2) Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place ("date of expropriation"), and shall not reflect any change in value occurring because the intended expropriation had become known earlier. Valuation criteria shall include going concern value, asset value including declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value.

(3) Compensation shall be paid without delay and be fully realizable.

(4) If payment is made in a G7 currency, compensation shall include interest at a commercially reasonable rate for that currency from the date of expropriation until the date of actual payment.

(5) If a Party elects to pay in a currency other than a G7 currency, the amount paid on the date of payment, if converted into a G7 currency at the market rate of exchange prevailing on that date, shall be no less than if the amount of compensation owed on the date of expropriation had been converted into that G7 currency at the market rate of exchange prevailing on that date, and interest had accrued at a commercially reasonable rate for that G7 currency from the date of expropriation until the date of payment.

(6) On payment, compensation shall be freely transferable as provided in Article 1109.

(7) This Article does not apply to the issuance of compulsory licenses granted in relation to intellectual property rights, or to the revocation, limitation or creation of intellectual property rights, to the extent that such issuance, revocation, limitation or creation is consistent with Chapter Seventeen (Intellectual Property).

(8) For purposes of this Article and for greater certainty, a non-discriminatory measure of general application shall not be considered a measure tantamount to an expropriation of a debt security or loan covered by this Chapter solely on the ground that the measure imposes costs on the debtor that cause it to default on the debt.

Exercises and questions for discussion

Agreement between the Government of the People's Republic of China and the Government of the Kingdom of Thailand for the Promotion and Protection of Investments (1985), Article 5(1)(a)
Only for the public interest and against compensation may either Contracting Party expropriate, nationalize or take similar measures... Such compensation shall be equivalent to the appropriate value of expropriated investments...

Agreement between the Government of the Republic of Finland and the Government of ___ on the Promotion and Protection of Investments, Article 5(1)
Investments by investors of a Contracting Party in the territory of the other Contracting Party shall not be expropriated, nationalised or subjected to any other measures, direct or indirect, having an effect equivalent to expropriation or nationalisation (hereinafter referred to as "expropriation"), except for a purpose which is in the public interest, on a non-discriminatory basis, in accordance with due process of law, and against prompt, adequate and effective compensation.

Transfer of funds

State A is the largest investor in State B. At the beginning of an economic crisis, State A's investors start rapidly to pull out investments from State B. The Prime Minister of State B imposes currency controls.

Consider the validity of the currency controls in light of the existence of an absolute right of transfer of funds in the BIT between State A and State B.
Assuming that BITs are to be made in the future between State B and other countries, how would you draft the provision on transfer of funds to provide fur such circumstances?

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THEME 5
Settlement of disputes

INTRODUCTION

Investment-related disputes could arise from various governmental measures that affect cross-border economic activities, some of which are addressed in investment agreements. IIAs put into place frameworks consisting of general and specific undertakings and obligations by the State party to such agreements that determine the scope, extent and manner of its involvement with the cross-border investment activities of their nationals. Within the context of the regulation and protection of the investment activities of transnational corporations, disputes might arise between States (State-State disputes) or between States and investors (investor-State disputes).

At the end of this theme, students should be able to:

- Distinguish between different dispute settlement procedures;
- Identify various issues concerning the scope and applicable standards for the settlement of disputes;
- Establish the link between the scope of disputes, the applicable standards for the settlement of disputes and the substantive provisions of the treaty; and
- Identify and analyse the economic and development implications for home and host countries of the applicable standards for the procedures.

HANDBOOK

1 State-State disputes

State-to-State (or "inter-State") disputes in IIAs can arise directly between the signatories of the agreement, or between investors represented by their home States and the host States.

State-to-State dispute settlement provisions in IIAs are textually diverse. However, the most common issues in IIAs concerning dispute settlement are the following:

- The scope of disputes that could trigger dispute settlement arrangements (DSAs);
- The procedures governing dispute settlement mechanisms;
- The applicable standards for the settlement of disputes;
- The nature and scope of outcomes of dispute settlement mechanisms;
- The compliance with dispute settlement awards.

1.1 The scope of disputes that could trigger dispute settlement arrangements

The determination of the nature and scope of disputes that trigger the DSA in an IIA involves the task of defining what kind of matters may give rise to a dispute. In this regard, DSA provisions define "matters" as those involving either the interpretation or the application of the provisions of the IIA, or both.

A related issue that completes the analysis is whether or not any limitations exist on recourse to a DSA, which will, by definition, circumscribe the types of disputes that could be submitted.

The typical formulations for DSAs refer to "disputes" (other terminology used are "differences", "divergences", "matters" or "questions") concerning or arising out of IIAs, without providing a formal definition of what is meant by the terminology. Thus, the first issue that might arise in a dispute is whether or not a genuine dispute exists that would trigger the DSA, which, would need to be defined.

In most instances, the term will, as long as there are no express indications to the contrary, be defined to cover as broad a range of disagreements between the parties as possible. It should be noted that a "legal dispute" could be considered as a "term of art", and connotes a particular set of circumstances between States.

Box 77

Elements of legal disputes

- **The claim must be formed under international law, which means that the claim should be based upon an act or omission that gives rise to State responsibility;**
- **The claim must be rejected or there must be a disagreement as to its disposition;**
- **The subject matter of the claim must be disposable through the application of international law, as evidenced by recourse to one or more of its accepted sources. However, there is no universal agreement concerning this last element.**

In this way, legal disputes are sometimes differentiated from "political disputes". If they appear in an IIA, "matters" or "questions" are intended to cover a much wider set of issues than "disputes".

However, in many IIAs, consultations may be available although there is no "dispute" between States as to the interpretation or application of a provision. A proposed measure or action could be the subject of consultations between the parties in areas of serious controversies so as to avoid or prevent a dispute from arising between the parties and to facilitate its settlement when it arises.

A given dispute, matter or question may relate to the "interpretation" or "application" of an IIA. The phrase "interpretation and/or application", when appearing in an IIA, is an all-encompassing formulation that mostly relates to issues or actions after the agreement has entered into force between the contracting parties.

Box 78

Interpretation and application

Interpretation is the determination of the meanings of particular provisions of an agreement in concrete or proposed situations.

Application relates to the extent to which the actions or measures taken or proposed by the contracting parties comply with the terms of an agreement, its object and purpose.

In practice, there is a large degree of overlap between the purport of "interpretation" or "application". A question of the application of an agreement will involve a question of its interpretation, and the interpretation of an agreement may be warranted by an action taken or proposed by a contracting party with respect to the subject matter of the agreement. Assessing the effects or implications of actions or measures taken or proposed by a contracting party with respect to the subject-matter of an agreement necessarily entails an interpretation thereof.

Thus, the nature and type of issues and the particular context within which they have arisen determine the scope of issues that could trigger the DSA in an IIA. Unless particular types of disputes are intended to be left outside the purview of the DSA in an IIA, the terminology typically used provides for a relatively wide scope of subject-matter, albeit that different processes, mechanisms or procedures might be applicable to different issues.

A parallel consideration is when certain matters covered by an IIA lie outside the scope of its DSA. This arises especially either where a particular exception is provided for (e.g. measures taken on the grounds of national security), or where alternative DSAs (such as investor-State provisions) are also included in the IIA. On the former issue, States might be reluctant to allow another party to challenge certain measures. As to the latter, where parallel DSAs exist, the question arises whether or not they could be simultaneously utilized. To the extent that the same issues are considered, and given the view that investor-State DSAs allow for a "de-politicization" of a dispute that would otherwise have to be resolved through inter-State channels, use of one DSA should preclude the concurrent engagement of another.

There are in any event three possibilities:

- Allow concurrent resort to the DSAs;
- Restrict resort to only one DSA by requiring a choice between the DSA;
- Limit resort to the DSAs, for example, by providing that only issues that are not being considered under investor-State procedures could be brought under the State-State DSA.

1.2 Dispute settlement mechanisms and their procedures

The mechanisms and procedures for the settlement of disputes determine, to a large degree, the manner and extent of control that the parties have over the outcome of the dispute settlement process. In their DSAs pertaining to State-State issues, IIAs predominantly provide for the initiation of dispute settlement processes through bilateral means. Some IIAs require that these bilateral attempts for the settlement of disputes must be engaged in as a pre-condition of having resort to binding arbitration.

The different types of bilateral and third party mechanisms for State-State dispute settlement are the following:

- Negotiations and consultations;
- *Ad hoc* inter-State arbitration, which is most prominently featured in IIAs;
- Permanent arbitral or judicial arrangements for dispute settlement;
- Political or administrative institutions whose decisions are binding.

1.2.1 Negotiations and consultations

Dispute settlement provisions typically first provide for mechanisms that utilise bilateral decision-making processes for dispute settlement, such as negotiations and/or consultations. A prevalent formulation refers to "diplomatic channels". Other formulations refer to "negotiations", "consultations", or both. All three formulations essentially involve a negotiation process. Negotiations and consultations are normally conducted on an ad hoc basis, even within an institutional setting. Their inherent flexibility does not easily make these mechanisms susceptible to any rigid procedural frameworks. Typically, the only procedural matter that is pre-determined with respect to these mechanisms is the timeframe within which they are to begin and end in order to avoid undue delays in settling the case.

Box 79

Negotiations and consultations – Example: USA BIT model, 2004

Article 37: State-State dispute settlement
1. Subject to paragraph 5, any dispute between the parties concerning the interpretation or application of this treaty, that is not resolved through consultations or other diplomatic channels shall be submitted upon the request of either party to a tribunal

Box 79

Negotiations and consultations – Example: USA BIT model, 2004

for a binding decision or award in accordance with applicable rules of international law. In the absence of an agreement by the parties to the contrary, the UNCITRAL Arbitration Rules shall govern, except as modified by the parties or this section.

1.2.2 *Ad hoc* arbitration

Party autonomy is the basic rule in the establishment of an arbitral tribunal (which may be a single individual or a group of individuals as decided by the parties). It is essentially an adjudicative process by a tribunal, except that the procedures for the establishment of the arbitral tribunal are effected either by the agreement of the disputing parties when a dispute arises (compromis), or by the operation of provisions negotiated previously and incorporated into DSAs (standard rules and procedures). These procedures normally address the following tasks:

- Selection of arbitrators, place, venue and official language for the proceedings;
- Determination of the terms of reference for the arbitral panel;
- Institution of time limits for the conduct of the arbitration proceedings and the promulgation of working rules for the panel and the parties, such as rules on the submission of case-briefs, arguments and evidence.

Box 80

***Ad hoc* arbitration – Examples**

BIT Estonia – Israel, 1994
Article 9(2): If a dispute between the contracting parties cannot thus [diplomatic channel] be settled within six (6) months from notification of the dispute, it shall, upon the request of either contracting party, be submitted to an arbitral tribunal."

BIT Japan – China, 1988
Article 13(2): "Any dispute between the contracting parties as to the interpretation or application of the present Agreement not satisfactorily adjusted by diplomacy shall be referred for decision to an arbitration board..."

1.2.3 Permanent arbitral and judicial institutions

In contrast to *ad hoc* arbitral tribunals, governments may choose to utilise the rules, procedures and facilities of specialised institutions for the arbitration of their disputes. The only arbitral institution that provides for the settlement of State-State disputes under its auspices is the Permanent Court of Arbitration in the Hague. The resort to a permanent institution with predetermined procedural rules for choosing the members of the arbitration panel and its proceedings might secure savings in terms of the time and resources committed to searching for potential candidates to be selected as an arbitrator, drafting an ad hoc arbitration agreement (or comparing and negotiating on proposed drafts from each involved party), looking for a convenient venue, and establishing a suitable set of procedural rules.

1.2.4 Permanent political institution for dispute settlement

The third-party settlement mechanism provided for in a DSA could be a political body or an organ of an international organization. There are permanent institutions with internal dispute settlement means that could instil finality to disputes. An example would be the Senior Economic Officials Meeting of the Association of South-East Asian Nations Investment Agreement.

1.3 Applicable law for the settlement of disputes

Without provisions in an applicable treaty (or a subsequent arbitration agreement) it is for the disputing parties in their negotiations or the tribunal to determine what laws, standards or principles are to be applied to the matters in dispute. The starting point (which does not require an express reference) is having regard for the rights and obligations provided for in the IIA itself, as well as in other relevant treaties between the parties. However, IIAs do not provide for all rules, standards or principles that might be applicable to a dispute.

Where the issue is provided for, reference is typically made to rules of (international) law. In some instances, however, this indication creates rather than solves problems in that their recognition is conditioned by requiring that all parties to the dispute must accept the particular principles or rules of international law. In addition to these legal standards, equitable principles (ex aequo et bono) and procedural standards might also be considered in DSAs.

When issues concerning an IIA arise between its signatories, their successful settlement turns in part on whether or not the law, rules and standards that are to be applied have been considered by and between the parties involved. For instance, there could be general agreement as to the applicable rules and standards, which would provide parameters for the decision-makers as to what criteria should be applied in reaching a decision. Generally, these rules and standards pertain to defining the nature and extent of the rights and obligations undertaken in the IIAs, which is a question of interpretation, or to the conformity of (proposed) measures undertaken by the parties thereto *vis-à-vis* those rights and obligations, as defined, which is an issue of application. The more precise the applicable rules and standards are defined in an IIA, the more guidance the court receives, which may make the outcome of the dispute more predictable.

Box 81

Applicable standards – Examples

BIT Argentina – El Salvador, 1995
Article 11(6): "The tribunal shall decide on the basis of the provisions of the agreement, legal principles recognized by the parties and the general principles of international law."

Energy Charter Treaty
Article 27(3)(g): "The tribunal shall decide the dispute in accordance with this treaty and applicable rules and principles of international law."

Chile BIT model
Article 9(6): "The arbitral tribunal shall reach its decisions taking into account the provisions of this Agreement, the principles of international law on this subject and the generally recognized principles of international law."

People's Republic of China BIT model
Article 8(5): "...The tribunal shall reach its award in accordance with the provisions of this agreement and the principles of international law recognized by both contracting parties."

1.4 Nature and scope of outcomes of dispute settlement mechanisms

With respect to bilateral processes of negotiation and consultation provided for in DSAs, the outcome could be a settlement agreement. The agreement would be binding upon the parties thereto, and its non-performance would entail State responsibility under international law.

However, in a situation in which a particular regime is established by an IIA involving a number of States (such as a regional agreement), there may be certain considerations that could render a binding agreement unacceptable, in the light of the purposes and objectives of the regime as a whole. Other States that are members of the regime may object to an agreement that, for example, provides for a looser application of its provisions between two parties, on the grounds that such an agreement would endanger the discipline imposed by the IIA.

Awards or judgments rendered through a tribunal are, by and large, binding upon the parties. In fact, it is this very feature that provides for a final decision on the settlement of a dispute. Once a State agrees that an award shall be binding, its non-compliance with the award entails State responsibility. Thus, as with settlement agreements, inter-State arbitration is likewise unproblematic, yet the special considerations regarding particular regimes equally hold here. In this connection, the finality of the awards, or recourse to an appeals process, deserves consideration.

Clearly, if binding arbitration is said to have the merits of a final and speedy settlement of the dispute, any review or appeals process would be an anathema. However, as IIAs become increasingly complex, the possibility of a genuine error in the determination of the dispute becomes more likely. An appeals procedure would allow for a reconsideration of the case where an error is alleged to have occurred at the first instance.

Box 82

Nature of outcomes – Examples

BIT China – Germany, 2003
Article 8: Settlement of disputes between contracting parties
6. The arbitral tribunal shall reach its award by a majority of votes. Such award shall be final and binding upon both contracting parties. The arbitral tribunal shall, upon the request of either contracting party, explain the reasons of its award.

Box 82

Nature of outcomes – Examples

BIT Argentina – Jamaica, 1994
Article 8: Settlement of disputes between the contracting parties
The arbitral tribunal shall reach its decision by a majority of votes. Such decision shall be binding on both contracting parties. Each contracting party shall bear the cost of its own member of the tribunal and of its representation in the arbitra1 proceedings; the cost related to the chairman and the remaining costs shall in principle be borne in equal parts by the contracting parties. The tribunal may, however, in its decision direct that a higher proportion of costs shall be borne by one of the two contracting parties, and this award shall be binding on both contracting parties. The tribunal shall determine its own procedure.

1.5 Compliance with dispute settlement awards

Compliance issues can be viewed from the standpoint of the parties to an inter-State dispute, the beneficiaries of IIAs, or the international system at large. In the final analysis, however, two factors must be considered:

- The legitimacy of the final decision concerning the settlement of a dispute, and the ability of the parties to comply with the terms of such decision. In this respect, negotiated settlements derive their legitimacy from the fact that the disputing parties enjoy a large degree of control over claims or matters involved and the settlement process. Tribunals derive their legitimacy from the agreement of the parties, their independence and impartiality, and their focus on the rule-based system of rights and obligations that allows them to assess the merits of the claims on an objective basis.

- How to avoid disputes that might arise in the event that a State does not comply with the final decision? In such circumstances, while the original dispute has been settled, another dispute might arise concerning the response to non-compliance, since under present international law, only unilateral decision-making structures or actions are available to respond to non-compliance with awards. In this connection, the procedures for establishing non-compliance – and the range, scope and manner of remedies – could be addressed. Nonetheless, most IIAs do not deal with this issue.

2 Investor-State disputes

Traditionally, dispute settlement under international law has involved disputes between States. Under customary international law, a foreign investor is required to seek the resolution of such a dispute in the tribunals and/or courts of the country concerned. Should these remedies fail or be ineffective to resolve a dispute – be it that they lack the relevant substantive content, effective enforcement procedures and/or remedies or are the result of denial of justice – an investor's main recourse is to seek diplomatic protection from the home country of the individual or corporation concerned. This is explicable on the basis that, by denying proper redress before its national courts, the host State may be committing a breach of international law, where such denial can be shown to amount to a violation of international legal rules. However, the remedy of diplomatic protection has notable deficiencies from an investor's perspective:

- First, the right of diplomatic protection is held by the home country of the investor and, as a matter of policy, it may decide not to exercise this right in defence of an investor's claim.

- Second, even if the home country successfully pursues an investor's claim, it is not legally obliged to transfer the proceeds of the claim to its national investor.

- Third, in the case of a complex transnational corporation with affiliates in numerous countries (each possessing, in all probability, a different legal nationality) and a highly international shareholder profile, it may be difficult to decide what the firm's nationality should be for the purposes of establishing the right of diplomatic protection on the part of a protecting State.

The increase of private commercial activities undertaken by individuals and corporations engaged in international trade and/or investment has raised the question whether such actors should be entitled to certain direct rights to resolve disputes with the countries in which they do business.

In this context, IIAs may offer mechanisms for the resolution of investor-State disputes that allow significant disagreements to be overcome and the investment relationship to survive. Equally, where the disagreement is fundamental and the underlying relationship is at an end, these mechanisms might help to ensure that an adequate remedy is offered to the aggrieved party and that the investment relationship can be unwound with a degree of security and equity, so that the legitimate expectations of both parties can, to some extent, be preserved.

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

Box 83

Consultation and negotiation – Examples

USA BIT model, 2004
Article 23: Consultation and negotiation
In the event of an investment dispute, the claimant and the respondent should initially seek to resolve the dispute through consultation and negotiation, which may include the use of non-binding, third-party procedures.

BIT Germany – China, 2003:
Article 9: Settlement of disputes between investors and one contracting party
1. Any dispute concerning investments between a contracting party and an investor of the other contracting Party should as far as possible be settled amicably between the parties in dispute.
2. If the dispute cannot be settled within six months of the date when it has been raised by one of the parties in dispute, it shall, at the request of the investor of the other contracting State, be submitted for arbitration.

Assuming that the investor and host State choose to use an international system of dispute settlement, a series of further choices arise. The most common issues in IIAs concerning investor-State disputes settlement are the following:

- The type of arbitration: *ad hoc* or institutional;
- The procedure to initiate a claim;
- The procedure to settle a claim;
- The enforcement of the award.

2.1 The type of arbitration

Where the parties have tried and failed to resolve their differences informally and to reach a negotiated settlement, the next choice concerns whether the parties wish to pursue *ad hoc* or institutional arbitration.

2.1.1 *Ad hoc* arbitration

It depends upon the initiative of the parties for their success. The parties must make their own arrangements regarding the procedure, the selection of arbitrators and administrative support. The principal advantage of ad hoc dispute settlement is that the procedure can be shaped to suit the parties. However, there are numerous problems associated with *ad hoc* arbitration.

Box 84

Problems associated with *ad hoc* arbitration

- The process is governed by the arbitration agreement between the parties. Its content depends on the relative bargaining power of the parties. The stronger party may therefore obtain an arrangement advantageous to its interests;
- It may be difficult to agree on the exact nature of the dispute, or on the applicable law;
- There may be difficulties in selecting appropriate arbitrators;
- The proceedings may be stultified by inordinate delay on the part of one side or both, or through the non-appearance of a party;
- There may be a problem in enforcing any award before local courts.

2.1.2 Institutional arbitration

An institutional system of arbitration is an alternative means of resolving a dispute than an *ad hoc* approach. It may have the advantage that arbitrators be selected from a roster, which might result in more consistent rulings than in the case of *ad hoc* arbitration. Once the parties have consented to its use, they have to abide by the system's procedures. These are designed to ensure that, while the parties retain a large measure of control over the arbitration, they are constrained against any attempt to undermine the proceedings. Furthermore, an award made under the auspices of an institutional system is more likely to be consistent with principles of procedural fairness applicable to that system and so is more likely to be enforceable before municipal courts. Indeed, recognition may be no more than a formality.

Box 85

Main systems for use in investor-State disputes

Two systems in particular appear suitable for use in investment disputes between a host State and a foreign investor:

ICSID System. The conciliation and arbitration procedures available under the auspices of the International Centre for Settlement of Investment Disputes. The ICSID system is the only institutional system of international conciliation/arbitration specifically designed to deal with investment disputes.

ICC System. The clauses of the International Chamber of Commerce Court of Arbitration have been used in IIAs, resulting in ICC arbitration in the event of a dispute. However, one of the criticisms lodged against the ICC Court of Arbitration as a forum for the resolution of foreign investment disputes is that, being primarily a centre for the resolution of commercial disputes between private traders, it has relatively limited experience in the complexities of long-term investment agreements involving a State as a party. This may account for the observation that ICC arbitration clauses are used relatively infrequently in international economic development agreements.

Box 86

Selection of forum – Example: BIT Bolivia – Argentina, 1994

Article 9:
"Where the dispute is referred to international arbitration, it may be submitted to:
(a) ICSID provided each contracting party is a party to the ICSID Convention. (For the interim period, both parties give their consent to the submission of the dispute to the ICSID Additional Facility Rules); or
(b) an *ad hoc* arbitration tribunal established under the UNCITRAL Arbitration Rules."

2.2 Procedure for initiating a claim

Under *ad hoc* procedures, the parties must agree on a method for initiating the claim. An institutional system prescribes a procedure. The principal aim of this procedure is to show that the dispute is submitted with the consent of the parties in accordance with any required procedural rules. It often involves the establishment and composition of the arbitral tribunal, a preliminary examination of the complaint by the secretariat (if attached to the system concerned) and the determination of the applicable law.

Establishment and composition of the arbitral tribunal. A basic question that needs to be determined is who sits on the tribunal, who is eligible to sit and in what numbers should they sit.

Admissibility. In *ad hoc* procedures, parties must decide for themselves which claims they submit to the tribunal. In contrast, in institutional systems, there are rules on admissibility. It must be stressed that the tribunal itself is normally the final judge of admissibility. In particular, the dispute must come within the jurisdiction of the tribunal:

- *Ratione materiae* in that the dispute must be one connected with an investment;
- *Ratione personae* in that the dispute is brought by an investor and/or a country that is entitled to use the institutional system concerned against the respondent investor or country that is capable of being sued under such system;
- *Ratione temporis* in that the dispute must have arisen at a time when the parties were legally entitled to have recourse in the system concerned.

Applicable law. In cases of international arbitration, two choices of law questions arise: which law governs the procedure of the tribunal and which substantive law governs the resolution of the dispute. In ad hoc procedures, the parties need to determine these issues. These may already have been determined by the investment agreement governing the investor-State relationship. However, such agreements may at times be unclear or even silent on these important questions, especially where the parties cannot accept each other's preferred governing law or laws. In such cases, the parties need to agree on the choice of law issues in the arbitration agreement that founds the tribunal and its jurisdiction.

By contrast, institutional systems specify rules on the choice of applicable law in their constitutive instrument. In the first place, the choice of procedural law is resolved by the applicability of the rules and procedures of the institutional system itself. These can be found in the constitutive instrument and in supplementary rules of procedure produced by that system. With regard to the choice of substantive law, preference is usually given to the parties' own choices in these matters, where the investment agreement concerned makes clear what these choices are. Where such clarity is absent, the applicable provision governs the determination of that question.

Nevertheless, the primary guiding principle concerning applicable law is the principle of party autonomy in choice of law matters, whether under an institutional or ad hoc system of arbitration.

Box 87

Arbitration rules – Examples

Article 36, Convention on the Settlement of Investment Disputes between States and Nationals of other States, ICSID (International Bank for Reconstruction and Development, 1965)
1. Any contracting State or any national of a contracting State wishing to institute arbitration proceedings shall address a request to that effect in writing to the Secretary-General who shall send a copy of the request to the other party.

2. The request shall contain information concerning the issues in dispute, the identity of the parties and their consent to arbitration in accordance with the rules of procedure for the institution of conciliation and arbitration proceedings.

3. The Secretary-General shall register the request unless he finds, on the basis of the information contained in the request that the dispute is manifestly outside the jurisdiction of the centre. He shall forthwith notify the parties of registration or refusal to register.

Article 3, Arbitration Rules of the United Nations Commission on International Trade Law (1976)
1. The party initiating recourse to arbitration (hereinafter called the "claimant") shall give to the other party (hereinafter called the "respondent") a notice of arbitration.

2. Arbitral proceedings shall be deemed to commence on the date on which the notice of arbitration is received by the respondent.

3. The notice of arbitration shall include the following:
(a) A demand that the dispute be referred to arbitration;
(b) The names and addresses of the parties;
(c) A reference to the arbitration clause or the separate arbitration agreement that is invoked;
(d) A reference to the contract out of or in relation to which the dispute arises;
(e) The general nature of the claim and an indication of the amount involved, if any;
(f) The relief or remedy sought;
(g) A proposal as to the number of arbitrators (i.e. one or three), if the parties have not previously agreed thereon.

Article 1, Permanent Court of Arbitration Optional Rules for Arbitrating Disputes between Two Parties of which only One is a State (1993)
(a) Where all parties have agreed in writing that a dispute that may arise or that has arisen between them shall be referred to arbitration under the Permanent Court of Arbitration Optional Rules for Arbitration of Disputes Relating to Natural Resources and/or the Environment, such disputes shall be settled in accordance with these Rules subject to such modification as the parties may expressly agree upon in writing. The expres-

Box 87

Arbitration rules – Examples

sion "agreed in writing" includes provisions in agreements, contracts, conventions, treaties, the constituent instrument of an international organization or agency or reference upon consent of the parties by a court. The characterization of the dispute as relating to the environment or natural resources is not necessary for jurisdiction, where all the parties have agreed to settle a specific dispute under these rules.

(b) Agreement by a party to arbitration under these Rules constitutes a waiver of any right of sovereign immunity from jurisdiction, in respect of the dispute in question, to which such party might otherwise be entitled. A waiver of immunity relating to the execution of an arbitral award must be explicitly expressed.

(c) The International Bureau of the Permanent Court of Arbitration (the "International Bureau") shall take charge of the archives of the arbitration proceeding. In addition, upon written request of all the parties or of the arbitral tribunal, the International Bureau shall act as a channel of communication between the parties and the arbitral tribunal provide secretariat services and/or serve as registry.

2.3 Enforcement of an award

A very important aspect of dispute settlement through third-party adjudication is that the resulting award is the final determination of the issues involved. However, to allow an award to stand where there is evidence of errors on the face of the record, or some suggestion of impropriety, would defeat the very purpose of such a dispute settlement technique. Accordingly, in the case of ad hoc awards, these may be regarded as unenforceable by reason of error of law, or procedural impropriety, under the municipal law of a country that is requested to enforce the award. By contrast, institutional systems of arbitration may provide procedures for the review of an award by another panel of arbitrators.

Where a dispute is resolved in national courts, the particular court concerned also has the means to ensure that its decision is executed by agents of the State with respect to persons and property within the State. By contrast, in cases of internationalized *ad hoc* arbitration, the arbitral tribunal has no direct powers of enforcement *vis-à-vis* either the investor or the host country with regard to persons and property in the host country. Naturally, this prompts the need for special award-enforcement mechanisms. If such enforcement mechanisms are not in place, or if they are inadequate, both the investor and the host State may find that a successful claim before an arbitral tribunal could lose its financial significance: there are no means of enforcing the tribunal's decision. In order to remedy this possible outcome, institutional systems of arbitration may provide for the enforcement of awards, made under their auspices, by the courts of all the countries that are parties to the system, subject only to specific rules concerning immunities of sovereign property from attachment in enforcement proceedings. Examples of such enforcement mechanisms are Article 54(1) of the ICSID Convention and the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards ("New York Convention").

A further procedural issue concerns the allocation of costs in a dispute settlement proceeding between an investor and the host State. Generally, the costs of arbitration are borne by the losing party on the basis of costs agreed by the parties at the outset of the proceeding. On the other hand, where institutional systems of arbitration are used, such costs may be pre-determined by the administrative bodies of that system. However, even under an institutional arrangement the parties concerned can still exercise considerable discretion when allocating costs.

Box 88

Awards – Example: USA BIT model, 2004

Article 34: Awards

1. Where a tribunal makes a final award against a respondent, the tribunal may award, separately or in combination, only:
(a) monetary damages and any applicable interest;
(b) restitution of property, in which case the award shall provide that the respondent may pay monetary damages and any applicable interest in lieu of restitution.
A tribunal may also award costs and attorneys' fees in accordance with this Treaty and the applicable arbitration rules.

Box 88

Awards – Example: USA BIT model, 2004

2. Subject to paragraph 1, where a claim is submitted to arbitration under Article 24(1)(b):
(a) an award of restitution of property shall provide that restitution be made to the enterprise;
(b) an award of monetary damages and any applicable interest shall provide that the sum be paid to the enterprise; and
(c) the award shall provide that it is made without prejudice to any right that any person may have in the relief under applicable domestic law.

3. A tribunal may not award punitive damages.

4. An award made by a tribunal shall have no binding force except between the disputing parties and in respect of the particular case.

5. Subject to paragraph 6 and the applicable review procedure for an interim award, a disputing party shall abide by and comply with an award without delay.

6. A disputing party may not seek enforcement of a final award until:
(a) in the case of a final award made under the ICSID Convention
(i) 120 days have elapsed from the date the award was rendered and no disputing party has requested revision or annulment of the award; or
(ii) revision or annulment proceedings have been completed; and
(b) in the case of a final award under the ICSID Additional Facility Rules, the UNCITRAL Arbitration Rules, or the rules selected pursuant to Article 24(3)(d)

Exercises and questions for discussion

1. What are the most common mechanisms to the settlement of disputes between States? Explain them.
2. What laws, standards or principles are to be applied to the matters in dispute?
3. What is the nature of the award in an arbitral settlement of disputes between States?
4. What are the most common mechanisms in the settlement of disputes between States and Investors, and how does it relate to diplomatic protection?
5. Explain the main features of the ad hoc arbitration mechanism in the case of investor-State disputes.
6. Describe the main elements of an institutionalised arbitral procedure in investor-State settlement of disputes.
7. Imagine that an investor from a country A has succeeded in an international investment dispute against country B. Country B refuses to recognize the award. What options does the investor have?

8. **Practical exercises**

   State-State dispute settlement

   In the following dispute settlement clause, identify if:

   - The scope of the disputes is included in the dispute settlement procedure and the kind of issues that are excluded from it.
   - It is possible to use diplomatic means before third party procedures.
   - It sets time limits for the use of diplomatic means.
   - It establishes the use of a third party mechanism and the procedure to begin it.
   - It establishes a procedure for the constitution of the third party body, along with time limits and provides for a procedure to avoid deadlocks due to a lack of selection of an arbitrator by one of the disputing parties.
   - It determines the applicable law.
   - It determined the panel's procedure and the applicable standards.
   - It establishes the nature of the outcome and deals with matters of non-compliance.
   - It determines the costs and their attribution.

Exercises and questions for discussion

Article 17: Settlement of disputes
(1) Any dispute between the contracting parties shall be settled amicably according to the following procedure:
(2) At the request of either contracting party, the dispute will be submitted to an arbitral tribunal for decision.
(3) An arbitral tribunal shall be constituted for each dispute. The contracting parties shall appoint the members of the arbitral tribunal. The chairman of the arbitral tribunal shall be appointed by agreement by the parties.
(4) The arbitral tribunal shall reach its decision by a majority of votes. Such decision shall be binding on both contracting parties. Unless otherwise agreed, the decision of the arbitral tribunal shall be rendered within six months of the appointment of the chairman.
(5) Each contracting party shall bear the costs of its own member of the tribunal and of its representation in the arbitral proceeding; the costs related to thecChairman and any remaining costs shall be decided by the arbitral tribunal.

Investor-State dispute settlement

In the following dispute settlement provisions, identify if:

- It defines the scope of the disputes that are included in the dispute settlement procedure and the kind of issues that are excluded from it.
- It is possible to use diplomatic means before third party procedures.
- It sets time limits for the use of diplomatic means.
- It establishes the use of third party mechanism and the procedure to start it.
- It establishes a procedure for the constitution of the third party body, along with time limits and provides for a procedure to avoid deadlocks due to a lack of selection of an arbitrator by one of the disputing parties.
- It determines the applicable law.
- It determines the panel's procedure and the applicable standards.
- It establishes the nature of the outcome and deal with matters of non-compliance.
- It determines the costs and their attributions.

Article 6
The present agreement shall also apply to investments made in the territory of one Contracting Party by investors of the other Contracting Party before the entry into force of the present agreement.

Article 8
All disputes concerning investments, in the sense of the present agreement, between one of the Contracting Parties and an investor from the other Contracting Party may be settled, at the request of the investor:
- either in the national jurisdiction of the Contracting Party involved in the dispute; or
- by international arbitration under the Convention on the Settlement of Investment Disputes between States and Nationals of other States, under the condition that the investors are "Nationals of another Contracting State", in the terms of article 25 of the aforementioned convention or the Chamber of Commerce of Paris.

The investor gives its consent in his request of arbitration and does so both in its name and in that of any legal company in the host Contracting Party that it controls and through which the investment has been made. It accepts, as well, that such company is considered as a "National of another Contracting State".
The arbitral award is binding on each of the Contracting Parties in the ways foreseen in their respective Code of Civil Procedure.

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Theme 6
Governmental measures

INTRODUCTION

The concept of governmental measures captures a vast array of methods implemented by countries relating to the operation of foreign investments. While home country measures (HCMs) refers to the whole range of national laws, regulations and policies that affect outward foreign direct investments, host country operational measures (HCOMs) refers to all measures implemented by States to influence the location and character of FDI and, in particular, to increase its benefits in the light of national objectives. Some of these are investment measures affecting trade flows, better known as trade-related investment measures. Often, HCOMs are also methods of intervention whose aim is to correct actual or perceived market distortions and incentives are part of these measures.

At the end of this theme, students should be able to:

- Distinguish between different categories of governmental measures;
- Identify different types of home country measures;
- Identify the main features of host country operational measures;
- Identify the categories of incentives; and
- Analyze economic and development implications of various types of provisions.

HANDBOOK

1 Home country measures

When used in the context of international investment instruments, the term "home country measures" refers to how such instruments might address a range of national laws, regulations and policies that affect outward foreign direct investments.

Historically, the term has drawn limited attention because HCMs fell under the unilateral authority of developed country governments that acted principally to promote the interests of their own investors. Nevertheless, these measures, which may restrict, permit or promote FDI, can influence both the quantity and quality of investment flows to developing countries. The resulting impact on development may be direct or indirect, deliberate or unintentional. Although no standardized classification of HCMs exists, six broad categories encompass the major types of HCMs that are used to promote or otherwise influence FDI flows:

- **Policy positions that encourage FDI to developing countries.** In general, such policy pronouncements set forth positions that would benefit the home country as well as host developing countries. Nevertheless, these statements could be linked to more substantive policy or programmatic commitments to development assistance, including actions involving other types of HCMs.

- **Information provision and technical assistance.** Information and technical assistance can help overcome market imperfections that sometimes cause disadvantages for developing countries. Promoting FDI in many developing countries must begin with fundamental steps to gather, publish and disseminate basic information regarding the countries' legal frameworks, macroeconomic circumstances, sectoral conditions and other factors that form the broad political and socio-economic context within which foreign enterprises look to invest. Developed countries can help collect and disseminate information on the investment climate and potential opportunities in developing countries, facilitating business contacts or even sponsoring "matching" programmes, particularly for small and medium-sized enterprises. Promotional HCMs may also offer technical assistance to developing countries that seek to enhance their investment climate, including support for regulatory reforms to improve transparency and administrative efficiency in areas of major concern to investors.

- **Technology transfer.** Some programmes tailor their support for FDI projects to encourage increased technology transfer or prioritize grants of assistance to promote specific technology-transfer objectives (for example, relating to environmental protection goals). Technology transfer can also be fostered by technical assistance that strengthens the receptive capacity of developing countries of FDI, in particular, that of technology intensive sectors.

- **Financial and fiscal incentives.** Development assistance institutions in some countries offer national enterprises direct financial support in the form of grants, loans or even equity participation for investment projects in eligible developing countries. Special support may be offered for FDI in designated industries, such as infrastructure projects, or for ventures undertaken by SMEs or with local business partners. Fiscal incentives (or disincentives) arise from HCMs relating to taxation, especially in the granting of tax exemptions, deferrals or credits for taxation of foreign source income, as well as general tax sparing provisions. Transfer pricing standards, monitoring, enforcement and information sharing arrangements can also affect FDI prospects.

- **Investment insurance.** Investment insurance represents a narrower but extensive, traditional category of HCMs aimed at promoting FDI. Most national and some regional or multilateral programmes offer coverage of political and other non-commercial risk not normally included under conventional, private insurance policies. These financial guarantee programmes promote FDI because the protected risk is generally higher in developing countries. Although the principal purpose of such HCMs is to protect their own national investors, the resulting offset of risk helps encourage FDI. Some investment insurance agencies provide associated promotional support specifically designed to encourage investment in development-oriented projects.

- **Market access regulations.** Market access regulations encompass trade-related measures dealing with matters such as product certification, country-of-origin definitions or preferential import regimes. These regulations can influence the comparative profitability of FDI in various developing countries, thereby affecting prospective investment decisions, particularly for export related facilities. HCMs that inhibit domestic market access for exports from overseas facilities, or conversely grant favoured treatment to imports from selected countries, impact on the distribution pattern of global FDI and trade flows.

- **Extraterritorial controls.** Although not a separate category of HCMs, extraterritorial controls constitute a related issue that cuts across the preceding categories. This particular method of implementing HCMs merits separate consideration because of its unusual and often controversial use. Applying national laws or regulations outside a home country's borders to TNC operations occurring within another sovereign political jurisdiction constitutes an extraterritorial extension of HCMs. Extraterritorial controls can include HCMs already discussed, such as taxation of foreign source income, as well as HCMs not previously identified, such as competition policy or trade controls. More broadly, the concept might also be used to extend HCMs in other areas, such as labour relations, the environment or corporate social responsibility standards.

From the perspective of private foreign investors, potential conflicts over national jurisdictions can act as disincentives to investment because TNCs do not want to be caught in the middle between home and host country laws, where they are subject to the authority and potential sanctions of two (or more) sovereign governments whose interests may conflict.

2 Host country operational measures

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

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

HCOMs can be classified into three categories:

- **Red light HCOMs.** First, there are HCOMs, which are explicitly prohibited at the multilateral level, i.e. by the WTO TRIMs Agreement. A number of interregional, regional and bilateral agreements also explicitly prohibit the same HCOMs (or, where these agreements are in a draft form, envisage their prohibition). To use a traffic light analogy, these are "red light" HCOMs, i.e. measures that the international community as a whole (or, more precisely, as represented in the WTO) has agreed should not be employed (although not all countries feel comfortable with the implementation of this agreement).

Box 89

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.** Additional HCOMs are explicitly prohibited, conditioned or discouraged by interregional, regional or bilateral (but not by multilateral) agreements. These are "yellow light" HCOMs in the sense that IIA negotiators ought to be aware that some countries (or groups of countries) have indeed prohibited them in some IIAs and perhaps would like to do so also at the multilateral level. Categorising these measures as yellow light HCOMs should not suggest that they are not as legally binding as the red light HCOMs. Indeed both derive from instruments governed by international law, which, among the parties, create binding legal obligations.

Box 90

Yellow light HCOMs

- **Requirements to establish a joint venture with domestic participation;**
- **Requirements for minimum level of domestic equity participation;**
- **Requirements to locate headquarters for a specific region or the world market;**
- **Employment performance requirements;**
- **Restrictions on sales of goods or services in the territory where they are produced or provided;**
- **Requirements to supply goods produced or services provided to a specific region or the world market exclusively from a given territory;**
- **Requirements to act as the exclusive supplier of goods produced or services provided;**
- **Requirements to transfer technology, production processes or other proprietary knowledge;**
- **Research and development requirements.**

- **All other HCOMs.** These are "green light" HCOMs. Such measures are generally not subject to control through IIAs although their use may be subject to other international obligations, e.g. to national treatment provision.

3 Incentives

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

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

There is no uniform definition in international law of what constitutes an "investment incentive". The only major international instrument that contains a partial definition is the WTO Agreement on Subsidies and Countervailing Measures (the SCM Agreement).

Box 91

Definition of subsidies, WTO Agreement on Subsidies and Countervailing Measures

Article 1: Definition of a subsidy

1.1 For the purpose of this agreement, a subsidy shall be deemed to exist if:

(a) (1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:

(i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);

(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);

(iii) a government provides goods or services other than general infrastructure, or purchases goods;

(iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments; or

(2) there is any form of income or price support in the sense of Article XVI of GATT 1994; and

(b) a benefit is thereby conferred.

Governments use three main categories of investment incentives to attract FDI and to benefit from it:

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

Incentives can be used for attracting new FDI to a particular host country (locational incentives) or for making foreign affiliates in a country undertake functions regarded as desirable such as training, local sourcing, research and development or exporting (behavioural incentives). Most incentives do not discriminate between domestic and foreign investors, but they sometimes target one of the two. In some countries, such as Ireland, the entire incentive scheme was geared to FDI for a long period.

Incentives may also favour small firms over large, or vice versa. They are offered by national, regional and local governments. Among the broad range of possible incentives, financial and fiscal incentives are most frequently employed. Developing countries often prefer fiscal instruments, such as tax holidays, concessionary tax rates, accelerated depreciation allowances, duty drawbacks and exemptions, whereas developed countries mainly use financial incentives, including cash grants (exceeding sometimes 50 per cent of the investment costs) and interest-free or subsidized loans. This may be seen as reflecting differences in wealth, as developed countries can afford to use up-front subsidies for inward investment whereas developing countries can, at best, afford to ease the tax burden *ex post*.

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

Box 92

Types of incentives

Fiscal incentives

- Profit-based: reduction of standard corporate income tax rate / profit tax rate / tax holiday;
- Capital investment-based: accelerated depreciation / investment and reinvestment allowance ;
- Labour-based: reduction in social security contribution / deductions from taxable earnings based on the number of employees or on other labor related expenditure;
- Sales-based: corporate income tax reductions based on total sales;
- Import-based: duty exemptions on capital goods;
- Export-based: export tax exemptions / duty drawback;
- Based on other particular expenses: corporate income tax deduction based on, for example, expenditures relating to marketing and promotional activities;
- Value-added-based: corporate income tax reductions or credits based on the net local content of outputs / granting income-tax credits based on net value earned;
- Reduction of taxes for expatriates.

Financial incentives

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

Non financial – other incentives

Subsidized services

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

Box 92

Types of incentives

Market Privileges

- **Preferential government contracts;**
- **Closing the market to further entry or the granting of monopoly rights;**
- **Protection from import competition;**
- **Special treatment with respect to foreign exchange, including special exchange rates, special foreign debt-to-equity conversion rates, elimination of exchange risks on foreign loans, concessions of foreign exchange credits for export earnings, and special concessions on the repatriation of earnings and capital.**

Source: WTO (1998); UNCTAD (1996b, 1996c).

Exercises and questions for discussion

1. What are governmental measures?
2. What are home country measures?
3. Cite and explain the different types of home country measures and their policy implications.
4. Cite and explain the different categories of host county operational measures and their policy implications.
5. Imagine that county A wants to attract foreign direct investment in a particular sector of its economy. What tools are available and what are the pros and cons?

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THEME 7
Other provisions (transparency, taxation and key personnel)

INTRODUCTION

This chapter presents and analyzes the issues of transparency, taxation and key personnel. Although these issues were not traditionally included in international investment agreements, the most recent agreements have dealt with them, given their importance for foreign investors and host countries.

At the end of this theme, students should be able to:

- Understand transparency provisions and its relationship to IIAs;
- Understand taxation provisions and its relationship to IIAs;
- Understand key personnel provisions and its relationship to IIAs; and
- Evaluate the nature of these provisions and its policy implications.

HANDBOOK

1 Transparency

The concept of transparency is closely associated with promotion and protection in the field of international investment. As a general term that is broadly synonymous with openness. Transparency implies the idea that any social entity should be prepared to subject its activities to (public) scrutiny and consideration.

Box 93

Transparency in relation to FDI

- **Transparency enhances the predictability and stability of the investment relationship and provides a check against circumvention and evasion of obligations, by resort to covert or indirect means;**
- **Transparency can serve to promote investment through the dissemination of information on support measures available from home countries, investment conditions and opportunities in host countries and through the creation of a climate of good governance, including, for example, a reduction of the likelihood of illicit payments in the investment process;**
- **Transparency is important for treatment and protection as without it, these cannot be assessed;**
- **Transparency is also necessary for the monitoring of disciplines, restrictions, reserved areas, exceptions and the like, that are provided for in IIAs;**
- **The extension of transparency obligations to corporate disclosure can help to protect the interests of host countries and home countries, as well as other stakeholders;**
- **The need for transparency is a logical corollary to certain established assumptions about the legal knowledge of individuals affected by the law, in particular, that ignorance of the law is no defense.**

Transparency provisions in an IIA are usually formulated in general terms imposing requirements on all parties to the agreement. The issue of transparency, as developed in IIAs, concerns a number of specific matters that can be summarized as follows.

1.1 The scope and objective of transparency provisions

The addressee of transparency requirements may depend on the objective and scope of a transparency provision and, more generally, on the nature of the agreement that contains the transparency provision. In the area of international investment, typically, the need for transparency is viewed from the perspective of foreign investors. Thus emphasis is usually placed on the desire of foreign investors to have full access to a variety of information in a host country that may influence the terms and conditions under which the investor has to operate.

At the same time, however, transparency issues may also be of particular concern to the host country in an investment relationship. At the broadest level of generality, the host country may wish to have access to information about foreign investors as part of its policy-making processes and for regulatory purposes. If the foreign investor is exempt from providing information on its operations to the host country, this will naturally not only undermine the capacity of the host country to assess the nature and value of the contribution being made by particular foreign investors, but also restrict its capacity to assess the appropriateness and effectiveness of its regulatory framework.

1.2 The content of transparency obligations

The content of transparency obligations is determined by the precise items of information to be made public by the relevant addressees.

In relation to governmental information, the range of items includes, at the least intrusive level, general policies that may be of importance to investment. This is followed, in terms of increasing intrusiveness, by laws and regulations and administrative rulings and procedures. Specific administrative decisions pertaining to individual cases are still more intrusive as they concern directly identifiable applications of policies, laws and regulations to individual cases. The same applies to information relating to a proposed law or regulation, which may be disclosed to allow interested parties the possibility of expressing their views on such a proposal before its final adoption.

On the other hand, judicial proceedings in open court are subject to a general duty of reporting in an open society; thus, a duty to disclose their content may be relatively unobtrusive, as it is part of a general commitment to the rule of law. An additional issue that arises in this connection concerns the cost of transparency, as it may impose a significant financial and administrative burden on developing countries, and least developed countries in particular.

In relation to corporate information, the range of items depends on a distinction between traditional disclosure for the purposes of the correct application of a national company, fiscal and prudential laws (e.g. anti-competitive conducts, transfer pricing, financial system stability) and newer items of "social disclosure" which are not always required under national laws, but which can serve to inform specific groups of stakeholders other than shareholders, as to the operations of the company in question, so that they can better understand the effects of its operations upon their vital interests. The latter type of information may be more intrusive, as it deals with a wider range of information than is traditionally required of corporations, and may require a greater devotion of time, expertise and resources to be delivered than mere financial information, which a company needs to compile as a matter of normal business management. The range of other stakeholders interested in such information potentially includes employees, trade unions, consumers, and the wider community as represented by governmental institutions at the local, regional and national levels.

1.3 Types of mechanisms that can be used to implement a transparency obligation

Four different modalities stemming from IIAs practice can be identified:

- Consultation and information exchange;
- Making information publicly available;
- Answering requests for information;
- Notification requirements of specific measures that need to be notified to the other party or to a body set up for this purpose under the agreement.

In each case, the modality can be:

- Voluntary or mandatory;
- Reciprocal and based on mutual agreement for disclosure;
- Unilateral obligation involving disclosure by one party only;
- An ad hoc obligation or part of a continuing and repeated process.

The weakest obligation would be a voluntary, mutually agreed *ad hoc* exchange or disclosure requirement while the strongest one would be a mandatory, unilateral and continuing obligation to disclose.

1.4 The timing of disclosure

The time limits set in an IIA for making information available or for meeting transparency requirements will also have a bearing on the content of the transparency obligation, as this will determine the speed with which the disclosure is to take place. Usually, the shorter the period of disclosure the more demanding the obligation will be. However, with regard to a requirement to make public or notify a draft law or regulation in order to afford interested parties the possibility to comment on such draft instruments, the degree of intrusiveness will increase with the length of time available to comment, as this may permit for a more searching disclosure process to be undertaken.

1.5 The possible safeguards and exceptions to transparency obligations

Safeguards, exceptions or reservations serve to reduce the overall impact of the transparency obligation in question.

Box 94

Categories of exceptions to transparency obligations

National security and defense. In some instances, foreign investors with investment projects in different countries may be prohibited from disclosing aspects of operations in one country to representatives of another country for national security reasons.

Law enforcement and legal processes. When a matter is the subject of judicial process or under investigation by a State, limits may be placed on the availability of information to third parties so as to protect the integrity of that process. Both countries and private entities participating in such procedures may benefit from this restriction.

Internal policy deliberations and premature disclosure issues. Both government and private entities will, out of necessity, engage in internal deliberations before taking policy decisions on a wide range of questions

Box 94

Categories of exceptions to transparency obligations

pertaining to investment. Where this is not inconsistent with a public policy right of information, such deliberations could be excluded from a transparency obligation.

Intrusiveness in the duty to inform. It may be a matter of discussion whether States should be required to provide information on the status of investment applications or to reveal each stage in the deliberative process (at the legislative and administrative levels) concerning foreign investment.

Protection of commercially confidential information or information that may affect the privacy rights of individuals. This obligation will be primarily placed upon countries rather than corporate or other private actors, who are the principal beneficiaries of this restriction. In this connection, the need to protect intellectual property is increasingly accepted as a basis for restricting transparency.

Box 95

Transparency provision – Example: USA BIT model, 2004

Article 11: Transparency

1. Contact Points

(a) Each party shall designate a contact point or points to facilitate communications between the Parties on any matter covered by this treaty.

(b) On the request of the other party, the contact points shall identify the office or official responsible for the matter and assist, as necessary, in facilitating communication with the requesting party.

2. Publication

To the extent possible, each party shall:

(a) publish in advance any measure referred to in Article 10 (1) (a) that it proposes to adopt; and

(b) provide interested persons and the other party a reasonable opportunity to comment on such proposed measures.

3. Notification and Provision of Information

(a) To the maximum extent possible, each party shall notify the other party of any proposed or actual measure that the party considers might materially affect the operation of this treaty or otherwise substantially affect the other party's interests under this treaty.

(b) On request of the other party, a party shall promptly provide information and respond to questions pertaining to any actual or proposed measure referred to in paragraph 3(a), whether or not the other Party has been previously notified of that measure.

(c) Any notification, request, or information under this paragraph shall be provided to the other party through the relevant contact points.

(d) Any notification or information provided under this paragraph shall be without prejudice as to whether the measure is consistent with this treaty.

2 Taxation

Tax provisions do not typically form a principal part of IIAs, partly due to the existence of tax-specific treaties: the double taxation treaties. The main reason for the limited role of taxation provisions in IIAs is that the inclusion of these matters can sometimes unduly complicate and draw out IIA negotiations and decrease the chances of successful conclusion.

Nonetheless, there exists a wide range of models of tax provisions in IIAs, ranging from an exclusion of such issues from a treaty to the inclusion of very specific tax issues, notably the use of taxation as a means of administrative expropriation; as an incentive for investors from other countries that are members of a regional economic integration organization formed among developing countries; as a general statement of the responsibility of transnational corporations in the area of taxation; and as the basis for a taxation regime for regional multinational enterprises or supranational business associations. The final model involves a commitment in an IIA to avoid the double taxation of investors and/or investments.

Despite the marginal treatment of taxation issues in IIAs, the proliferation of DTTs is one important indication that taxation has far-reaching implications for the conduct of FDI operations. DTTs themselves typically have clauses excluding national and most-favoured-nation treatment from tax matters; and bilateral investment treaties, which provide for national and MFN treatment, typically exclude taxation from those provisions. This exemplifies the sensitive nature of the sovereign right of a State to tax. Even in cases where there is no double taxation to relieve (e.g. if there is no tax in one State or if the country of residence unilaterally avoids double taxation), a tax treaty can be useful as it generally offers greater and more comprehensive protection than that available under domestic rules, which can be modified at will. Indeed, the single most important advantage of a tax treaty is the relative legal certainty if offers to investors with respect to their tax position in both the source and residence countries.

Box 96

Tax provisions in IIAs

In IIAs and international tax arrangements, approaches and models have evolved in relation to the jurisdiction to tax:
- **Exclusion of tax issues model;**
- **Qualified exclusion model;**
- **Tax incentives model;**
- **Transnational corporation tax responsibility model;**
- **Regional multinational enterprise taxation model.**

2.1 The exclusion of tax issues model

As mentioned earlier, the vast majority of IIAs have excluded taxation issues from their content. The majority of BITs make taxation matters exceptions to the MFN and national treatment principles. Such an exception permits a contracting party to provide favourable tax treatment to investment by investors of another country without according the same treatment to investment by investors of third countries with which it has BITs.

The reasons for this exception in BITs are that:

- Many countries prefer to address international taxation issues in separate treaties dealing specifically with such matters.
- It allows the ability to maintain maximum fiscal sovereignty.
- The exception allows a country to conclude a tax treaty granting special tax treatment to investment from another country in return for concessions, without having to worry that other countries will have the right to the same treatment by virtue of the MFN provision in their BITs.
- The complexity of tax matters may render such matters unsuitable for inclusion in the kind of standardized provisions that are typical of BITs.

Box 97

Exclusion of taxation issues – Example: BIT Germany – China, 2003

Article 3: Treatment of Investment
(4) The provisions of Paragraphs 1 to 3 of this article shall not be construed so as to oblige one contracting party to extend to the investors of the other contracting party the benefit of any treatment, preference or privilege by virtue of (...)
(b) Any double taxation agreement or other agreement regarding matters of taxation.

2.2 The qualified exclusion model

Certain IIAs that do contain a general exclusion of taxation issues qualify it with references to specific taxation matters that materially affect the enjoyment, by an investor, of certain protective rights under the agreement.

Box 98

Qualified exclusion model – Examples

Energy Charter Treaty (ECT)
Article 21(1)
"Except as otherwise provided in this article, nothing in this treaty shall create rights or impose obligations with respect to taxation measures of the contracting parties..."

USA BIT model, 2004
Article 21: Taxation
1. Subject to paragraph 3, no provision of this treaty shall impose obligations with respect to taxation meaures, except for:
(a) Article [Expropriation];
(b) Article [Performance Requirements](2)-(4);
(c) Articles [investor-State dispute settlement] and [State-State dispute settlement] with respect to a claim of breach of article [expropriation] or article [performance requirements] (2)-(4); and
(d) Article [investor-State] with respect to a claim of breach of an investment agreement or an investment authorization.

Box 98

Qualified exclusion model – Examples

2. With respect to the application of article [expropriation] referred to in paragraph 1, a claimant that asserts that a taxation measure involves an expropriation may submit a claim to arbitration under Section B, only if:

a) The claimant has first referred to the competent tax authorities* of both parties in writing the issue of whether that taxation measure involves an expropriation; and

b) Within 180 days after the date of such referral, the competent tax authorities of both parties fail to agree that the taxation measure is not an expropriation.

3. Nothing in this treaty shall affect the rights and obligations of either party under any tax convention. In the event of any inconsistency between this treaty and any such convention, that convention shall prevail to the extent of the inconsistency. In the case of a tax convention between the parties, the competent authorities under that convention shall have sole responsibility for determining whether any inconsistency exists between this Treaty and that convention.

* For the purposes of this article, the "competent tax authorities" means:

(a) for the United States, the Assistant Secretary of the Treasury (Tax Policy), Department of the Treasury; and

(b) for [Country]

2.3 The tax incentives model

A common taxation provision in a significant number of regional investment agreements among developing countries aims at setting down a regime of tax incentives for investors from other member countries of the region. Commonly such provisions include: reducing the overall level of taxation to be levied on investors who qualify for the preferential treatment, protecting the level of taxation charged on foreign investors with reference to the national treatment standard, guaranteeing the free transfer of assets without special taxation, or seeking to harmonize tax rates across the region (refer to Module 3, theme 6 on incentives).

Box 99

Tax incentives model – Examples

- **The Common Convention on Investments in the States of the Customs and Economic Union of Central Africa (UDEAC, 1965), in Part III offers reduced taxation for companies that are entitled to such treatment under the agreement and a variety of schemes of tax reduction.**
- **The Agreement on the Harmonisation of Fiscal Incentives to Industry (Caribbean Common Market, 1973) offers a scheme of fiscal benefits to approved enterprises.**
- **The Unified Agreement for the Investment of Arab Capital in the Arab States (1980), in article 7, guarantees the freedom to transfer capital, without the transfer process incurring any taxes or duties. Articles 16-17 of the agreement, which deal with investor privileges, do not mention taxation, but this may be implicit in the freedom granted to the contracting parties to offer privileges in excess of the minimum stipulated within the agreement.**
- **The Agreement on Promotion, Protection and Guarantee of Investments among Member States of the Organisation of the Islamic Conference (1981), in Article 4, mentions tax incentives.**
- **The Community Investment Code of the Economic Community of the Great Lakes Countries (CEPGL, 1982), in Title II, offers extensive tax advantages to qualifying enterprises, especially in section III, articles 28-29 (tax advantages) and in chapter II, section I, articles 31-36 (tax advantages).**
- **The Fourth ACP-EEC Convention of Lomé (1989), in Part III, title III, chapter 5, section 6, mentions tax and customs arrangements.**

2.4 The TNC tax responsibility model

Several codes and declarations concerning the conduct of transnational corporations have included provisions on taxation. These provisions generally call for tax responsibility on the part of TNCs such that firms are urged to cooperate with tax authorities of the countries in which they generate taxable income by offering full disclosure of their profits and losses in accordance with national laws and practices, by not engaging in tax avoidance manipulations, particularly transfer pricing practices, and by paying all due taxes.

Box 100

Tax responsibility model – Examples

- The Caribbean Community (CARICOM) Agreement, in article 40, introduces a programme for the harmonization of fiscal incentive.
- The Treaty Establishing the Latin American Integration Association (LAIA) (1980), in article 46, introduces the national treatment principle as regards, *inter alia*, taxes charged on products originating from the territory of another member country.

2.5 The regional multinational enterprise taxation model

A specialized taxation provision can usually be found in agreements setting up a regional multinational enterprise or other supranational form of business association. Where such an enterprise or business association is established, the constitutive agreement must determine in what manner and in which place the entity in question will be taxed. Thus, for example, the enterprise may be obliged to pay tax in the place where its principal seat or place of incorporation is located. Alternatively it may be absolved from paying tax altogether where it is seen to be a vehicle of economic development for the region and where a degree of preferential treatment for the entity is deemed desirable.

Box 101

Regional multinational enterprise taxation – Examples

The **Guidelines for Multinational Enterprises** of the 1976 OECD Declaration on International Investment and Multinational Enterprises assert that enterprises should:

1. Upon request of the taxation authorities of the countries in which they operate provide, in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations, including relevant information concerning their operations in other countries;
2. Refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed.

The **Draft United Nations Code of Conduct on Transnational Corporations**, paragraph 34, states:
Transnational corporations should / shall not, contrary to the laws and regulations of the countries in which they operate, use their corporate structure and modes of operation, such as the use of intra-corporate pricing which is not based on the arm's length principle, or other means, to modify the tax base on which their entities are assessed.

2.6 The avoidance of double taxation model

This issue is dealt with by both IIAs and double taxation agreements. The former may incorporate a provision encouraging the contracting parties to deal with the problem of double taxation as a part of their mutual obligations under an IIA. The modality of dealing with this issue may be specified through an obligation to conclude a double taxation agreement between the parties. Alternatively, there may simply be a general commitment to avoid double taxation. With regard to international tax arrangements, these contain numerous clauses that are of direct relevance to the treatment of investors and investment and to the avoidance of double taxation in particular.

Box 102

Avoidance of double taxation – Examples

Treaty Establishing the Common Market for Eastern and Southern Africa (1993)
The member States undertake to conclude between themselves agreements on the avoidance of double taxation.

Asia-Pacific Economic Cooperation (APEC) Non-Binding Investment Principles
Member economies will endeavour to avoid double taxation related to foreign investment.

Agreement on Arab Economic Unity (1957), article 2(7)(b):
Avoiding double taxation and duties levied on the nationals of the contracting parties.

3 Key personnel

International agreements that lay down rules concerning the treatment of foreign investment, such as BITs and free trade agreements that include rules on treatment and protection of foreign investment, generally, do not address employment issues. Some of these agreements, however, prohibit host countries from imposing nationality requirements upon foreign investors with respect to the appointment of senior management. An example is Article 1107 (1) of the NAFTA.

Box 103

NAFTA, Article 1107

No party may require that an enterprise of that party that is an investment of an investor of another party appoint to senior management positions individuals of any particular nationality.

Closely related to this are provisions in some agreements on intra-company transferees, which, albeit subject to national law, require host countries to permit the temporary entry and stay of certain categories of key personnel, employed by investors.

Box 104

BIT Canada – Costa Rica, Article V (3)

Subject to its laws, regulations and policies relating to the entry of aliens, each contracting party shall grant temporary entry to citizens of the other contracting party employed by an enterprise or a subsidiary or affiliate thereof, in a capacity that is senior managerial or executive or requires specialized knowledge. For further certainty, however, nothing in this article shall be interpreted as an authorization to carry on a professional practice in the territory of a contracting party.

Exercises and questions for discussion

1. What is the meaning of the concept of transparency in the context of an IIA?
2. Cite and explain the main features of transparency in investment instruments.
3. Why are taxation issues of particular importance in the context of IIAs.
4. Cite and explain the different approaches of taxation issues in the context of IIAs.
5. Imagine that a foreign investor wants to employ key personnel of his country of origin in host country X. Do IIAs usually give him a right to do so?
6. How would you define the term "key personnel"?

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Theme 8
Implementation issues

INTRODUCTION

The proliferation of IIAs results in a multi-layered, multi-faceted and intricate web of international obligations and disciplines. This poses a challenge to countries to cope with and implement multiple commitments in investment that may overlap one another, be inconsistent or leave gaps, as well as to translate them adequately into their national systems. Implementation is therefore a key issue for a timely and adequate application of the provisions contained in investment instruments. However, the challenge of implementation is even more complex given the fact that a number of agreements are not ratified, some are being renegotiated and investor-State disputes are proliferating. This further points to the importance of implementation.

At the end of this theme, students should be able to:

- Understand what entail implementation issues relating to IIAs;
- Understand entry into force and ratification processes; and
- Evaluate the implications of investor-State disputes.

HANDBOOK

1 Implementation issues

All countries are faced with the task of implementing their international obligations in the area of investment. Specifically, they need to:

- Ratify agreements;
- Ensure the conformity of national frameworks with international commitments;
- Ensure coherence in their international obligations which arise out of various agreements;
- Manage investment disputes effectively;
- Clarify/elaborate future policy positions and how they can be reflected in new treaties;
- Monitor developments with regard to the existing international regulatory framework for investment.

The policy aspects of implementation (conformity, coherence, policy positions and monitoring) are covered by Module 2, theme 2 of this teaching material. This theme is then focusing on the legal aspects (ratification and management of investment disputes).

Implementation is a key issue for a timely and adequate application of the provisions contained in investment instruments. However, recent trends showed some shortcomings in this area. A number of agreements are not implemented, i.e. are either not ratified by national parliaments or not properly acted upon by relevant authorities. Furthermore, investment treaties have a limited duration and, given the constant evolution of international law on investment, several countries are embarking on the renegotiation of existing treaties. Finally, the current proliferation of investor claims brought forward under investor-State dispute settlement mechanisms made available by bilateral and regional investment agreements adds to complication in this regard, further pointing to the importance of implementation.

2 Ratification of bilateral investment treaties

In 2004, 78 BITs entered into force, bringing the total number of BITs in force to over 1,718 (according to available information). Hence, about 30 per cent of the total number BITs signed (2,392 BITs as of the end of 2004) had not yet been ratified and, consequently, had not entered into force at the end of 2004. The proportion is even higher for BITs concluded by developing economies and LDCs. Indeed the ratio of non-ratified BITs by developing countries is 50 per cent, while the ratio for BITs concluded by LDCs is 52 per cent.

The formal requirements for the ratification process of BITs vary from country to country according to the constitution and legislative procedures (see examples of ratification procedures in the annex). In some countries, for example, the ratification of a treaty may require the enactment of an implementing legislation, which, in turn, may require major adaptations of relevant legislation. Going through these steps may take up to an average of two years if not more. These aspects require coordination among the institutions driving the process, including proper briefing of parliamentarians, relevant ministries and interest groups that may further slow down the process. This may hold particularly true for developing countries and LDCs that often lack necessary technical expertise and institutional organization due to insufficient financial resources.

However, the signing of a BIT (even if it did not enter into force) still has some legal implications for the protection and promotion of foreign investments. Indeed, as far as the legal implications of not ratifying a BIT are concerned, two issues are raised that are related to the legal protection of investors in the territory of the host State:

- The first issue concerns the **applicability of the substantive provisions of a treaty although not ratified**. According to article 18 of The Vienna Convention on the Law of Treaties (obligations not to defeat the object and purpose of a treaty prior to its entry into force), there is an obligation to adhere to commitments contained in signed treaties, regardless of whether they have been ratified, unless there is a valid reason not to do so.

Box 105

Vienna Convention on the Law of Treaties, Art. 18

Article 18: Obligations not to defeat the object and purpose of a treaty prior to its entry into force

"A State is obliged to refrain from acts which would defeat the object and purpose of a treaty when:

(a) it has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval, until it shall have made its intention clear not to become a party to the treaty; or

(b) it has expressed its consent to be bound by the treaty, pending the entry into force of the treaty and provided that such entry into force is not unduly delayed."

- The second legal issue concerns the **availability for the investor of recourse to investor-State dispute settlement mechanisms**, and, more specifically, the availability of the consent to arbitration given by the countries signatories to bilateral investment treaties. As there is only limited case law on this issue,[44] it appears that it could be difficult for an investor to invoke consent under a treaty that has not been ratified.[45] Consent to arbitration may however be afforded to the investor through other instruments or the national laws.

3 Entry into force and ratification of treaties

The entry into force and ratification of international investment treaties do not differ from any other international treaties and therefore follow the rules of the international law of treaties.

Commonly, treaty provisions determine the date on which the treaty enters into force. Bilateral treaties may provide for their entry into force on a particular date, upon the day of their last signature, upon exchange of the instruments of ratification or upon the exchange of notifications.

[44] See *Ceskoslovenska Obchodni Banka, A.S. vs the Slovak Republic*, Decision on jurisdiction, 24 May 1999, ICSID.

[45] This may be so even under the broadest interpretation of Article 18 of the Vienna Convention. It would be difficult to justify such a significant derogation from State sovereignty, absent ratification, or the inclusion of a specific provision mandating "provisional application" of the treaty, including its dispute resolution provisions, subject to the constitution, laws or regulations of the Signatory State, as is the case in Article 45 of the Energy Charter Treaty.

Box 106

Entry into force provision – Examples

BIT Germany – China, 2003
Article 15: Entry into Force, Duration and Termination
(1) This Agreement shall enter into force one month from the date on which both Contracting Parties have notified each other in writing that the national requirements for such entry into force have been fulfilled. The relevant date shall be the day on which the last notification is received. (...)

USA BIT model, 2004
Article 22: Entry into Force, Duration, and Termination
1. This Treaty shall enter into force thirty days after the date of exchange of instruments of ratification. It shall remain in force for a period of ten years and shall continue in force unless terminated in accordance with paragraph 2.

In cases where multilateral treaties are involved, it is common to provide for a minimum number of States to express their consent for entry into force. Some treaties provide for additional conditions to be satisfied, e.g., by specifying that a certain category of States must be among the consenters. The treaty may also provide for an additional time period to elapse after the required number of countries has expressed their consent or the conditions have been satisfied. A treaty enters into force for those States which gave the required consent. A treaty may also provide that, upon certain conditions having been met, it shall come into force provisionally.

Box 107

Vienna Convention on the Law of Treaties, Art. 14

Article 14: Entry into force
1. A treaty enters into force in such manner and upon such date as it may provide or as the negotiating States may agree.

2. Failing any such provision or agreement, a treaty enters into force as soon as consent to be bound by the treaty has been established for all the negotiating States.

3. When the consent of a State to be bound by a treaty is established on a date after the treaty has come into force, the treaty enters into force for that State on that date, unless the treaty otherwise provides.

4. The provisions of a treaty regulating the authentication of its text, the establishment of the consent of States to be bound by the treaty, the manner or date of its entry into force, reservations, the functions of the depositary and other matters arising necessarily before the entry into force of the treaty apply from the time of the adoption of its text.

According to this article, when the treaty does not specify a date, there is a presumption that the treaty is intended to come into force as soon as all the negotiating States have consented to be bound by the treaty.

Box 108

Vienna Convention on the Law of Treaties, Art. 11

Article 11: Means of expressing consent to be bound by a treaty
The consent of a State to be bound by a treaty may be expressed by signature exchange of instruments constituting a treaty ratification, acceptance, approval or accession or by any other means if so agreed.

Ratification defines the international act whereby a State indicates its consent to be bound to a treaty if the parties intended to show their consent by such an act. States may express their consent to be bound by an "exchange of letters/ notes" (Article 13 of the Vienna Convention on the Law of Treaties, 1969). The instruments of "acceptance" or "approval" of a treaty have the same legal effect as ratification and consequently express the consent of a State to be bound by a treaty. In the practice of certain States, acceptance and approval have been used instead of ratification when, at a national level, constitutional law does not require the treaty to be ratified by the head of State (Articles 2 (1) (b) and 14 (2) of the Vienna Convention on the Law of Treaties).

In the case of bilateral treaties, ratification is usually accomplished by exchanging the requisite instruments, while in the case of multilateral treaties the usual procedure is for the depositary to collect the ratifications of all States, keeping all parties informed of the situation. The institution of ratification grants States the necessary timeframe to seek the required approval for the treaty on the domestic level and to enact the necessary legislation to give domestic effect to that treaty (Articles 2 (1) (b), 14 (1) and 16 of the Vienna Convention on the Law of Treaties).

However, procedures for entry into force of international agreements vary from country to country and depend upon of the status of international law in the domestic law.[46]

By way of example, in parliamentary systems based on the UK model, treaties only become part of domestic law if an enabling act of the parliament has been passed.[47] Returning to the international legal theories, this approach reflects the theory of dualism in its requirement that a treaty be transformed into domestic law through an act of parliament.

The basis of this approach is found in the doctrine of the separation of powers. The executive is empowered to conclude treaties at the international level. If treaties could become part of domestic law without an act of parliament, the executive, in effect, would be able to bring about a substantial change to domestic law without control by the legislative arm of government.

In contrast to the position in parliamentary systems of the UK type, the constitutional framework in the US allows for treaties to become part of domestic law without being transformed through legislation. The US Constitution provides for treaties to which the US is a party to become the law of the land (Article VI). This provision was intended to assure the supremacy of treaties over the laws of the US States.[48]

This position under US law can be considered also in the context of the doctrine of the separation of powers. Unlike parliamentary systems, where the approval of parliament is not required for the executive act of becoming party to a treaty, the US Constitution requires that the Senate gives its "advice and consent" to the President making a treaty (Article II, section 2.). Accordingly, a treaty will not become the law of the land without the approval of the Senate. As such, there is a legislative check of the power of the executive to conclude treaties.

Box 109

Constitution of the United States of America, Article II, Section 2, Clause 2

He [the President] shall have Power, by and with the Advice and Consent of the Senate, to make Treaties, provided two thirds of the Senators present concur; and he shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

Because of this constitutional position, treaties in the US context are often referred to as "self-executing". However, not all treaties will be self-executing. In some circumstances, legislation may be required. For example, a treaty "cannot itself enact criminal law".[49] If a treaty required parties to criminalize certain acts, the US Congress would have to enact an appropriate law.

[46] The theory of dualism, for example, contends that international law and domestic law are separate legal orders. Accordingly, international law cannot operate directly in the domestic sphere, needing to be transformed into domestic law by the legal acts of States. In some countries, for example, the ratification of a treaty may require the enactment of an implementing legislation, which, in turn, may require major adaptations of relevant legislation. On the other hand, the theory of monism views all law as part of the same universal normative order. As such, international law does not need to be transformed to apply in the domestic legal order.

[47] See Brownlie (1998: 46).

[48] See Henkin (1996: 199).

[49] *Ibid.*

Box 110

Treaties and domestic law – Examples

Constitution of the USA, Article VI, Clause 2:
This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Basic Law of Germany, Article 59 (Authority to represent the Federation in its international relations)
(1) The Federal President represents the Federation in its international relations. He concludes treaties with foreign States on behalf of the Federation. He accredits and receives envoys.

(2) Treaties which regulate the political relations of the Federation or relate to matters of Federal legislation require the consent or participation, in the form of a Federal law, of the bodies competent in any specific case for such Federal legislation. For administrative agreements the provisions concerning the Federal administration apply mutatis mutandis.

Constitution of France, Title VI: treaties and International Agreements
Article 52
The President of the Republic shall negotiate and ratify treaties. He shall be informed of any negotiations for the conclusion of an international agreement not subject to ratification.

Article 53
Peace treaties, commercial treaties, treaties or agreements relating to international organization, those that commit the finances of the State, those that modify provisions which are matters for statute, those relating to the status of persons, and those that involve the cession, exchange or addition of territory, may be ratified or approved only by virtue of an Act of Parliament. They shall not take effect until they have been ratified or approved. No cession, exchange or addition of territory shall be valid without the consent of the population concerned.

Article 53-1
The Republic may conclude, with European States that are bound by commitments identical with its own in the matter of asylum and the protection of human rights and fundamental freedoms, agreements determining their respective jurisdiction in regard to the consideration of requests for asylum submitted to them. However, even if the request does not fall within their jurisdiction under the terms of these agreements, the authorities of the Republic shall remain empowered to grant asylum to any foreigner who is persecuted for his action in pursuit of freedom or who seeks the protection of France for some other reason.

Article 53-2
The Republic may recognize the jurisdiction of the International Criminal Court as provided by the treaty signed on 18 July 1998.

Article 54
If the Constitutional Council, on a reference from the President of the Republic, from the Prime Minister, from the President of one or the other assembly, or from sixty deputies or sixty senators, has declared that an international commitment contains a clause contrary to the Constitution, authorization to ratify or approve the international commitment in question may be given only after amendment of the Constitution.

Article 55
Treaties or agreements duly ratified or approved shall, upon publication, prevail over Acts of Parliament, subject, in regard to each agreement or treaty, to its application by the other party.

Ratification is however, only the first step of implementing a treaty. It has to be followed by the actual implementation of the provisions of a treaty, including ensuring coherence between treaty commitments and national policies and strategies, as well as adequately informing the main beneficiaries of treaties, i.e. the foreign investors. Many developing economies are lagging behind in these implementation steps, leading, at times, to costly disputes and other effects that run counter to the purposes of entering into international commitments.

4 Managing international investment disputes

Treaty provisions on investor-State dispute settlement are increasingly being utilized by investors with serious development implications (refer to Module 3, theme 5). The proliferation of IIAs at the bilateral, regional and interregional levels is part of the efforts exerted by countries to attract FDI by creating a more stable, transparent and predictable environment for foreign investors. However, more IIAs also mean more legal protection for the investor, which represent an increased risk of investment dispute cases.

As mentioned in Module 2, theme 2, the cumulative number of treaty-based cases brought before the World Bank Group's International Centre for Settlement of Investment Disputes and other arbitral fora has been rising dramatically over the past five years, reaching at least 183 known claims by June 2005. At least 57 governments, 36 of them in the developing world, have faced investment treaty arbitration. The financial implications of the investor-State dispute settlement process can be substantial, from the point-of-view of the costs of the arbitration proceedings, lawyers' fees and the awards rendered.

The surge in investment disputes arising from IIAs, and the costs incurred from these disputes, signify that governments that decide to enter into IIAs need to be judicious in negotiating and implementing such agreements. They also need to be sensitive to actions that could trigger litigation and to closely follow the development and management of such disputes when they arise. This relates especially to developing country governments that are often at a loss with investor claims and have little or no experience in the management of disputes. In addition, they lack both the institutional and practical expertise to deal with them. This could lead to potential high risks – given the amounts at stake – and adverse effects on development.

The main features of managing investment disputes range from:

- Understanding various dispute settlement systems (*ad hoc*/institutional arbitration);
- Understanding various arbitration rules;
- Making the necessary institutional arrangements to handle claims in the most efficient way;
- Practical preliminary steps to be taken once facing a claim: handling various steps before the arbitration procedure starts (handling the amicable settlement period, handling a notice of intent, appointment of arbitrators, hiring counsel, negotiating counsel fees);
- Making the appropriate choice of venue;
- Handling different phases of a claim: introduce objections to jurisdiction, counter-claims; prepare briefs, research jurisprudence.

International investment rule making is likely to further intensify in the years to come, although probably with a shift in emphasis regarding the type of agreement – i.e. from BITs to PTIAs – and on their scope – i.e. from narrow to broader coverage of investment. Indeed, a large number of IIAs are currently under negotiation and/or re-negotiation, suggesting an even more pronounced increase in the coming years. Hence, whatever the fate of investment discussions in the WTO, the international framework of investment rules continues to expand at the bilateral, subregional, regional and interregional levels. This suggests that the present system of multifaceted and multilayered investment agreements will become even more complex in the near future, raising, even further, the likelihood of conflicting rules and investment disputes, as well as costs of compliance for both governments and business of the parties to the agreements.

Exercises and questions for discussion

1. What does the implementation of an investment agreement at the bilateral, regional and international level entail?
2. Explain and analyze the treaty ratification process in your country.
3. Is it possible to invoke the applicability of a treaty although not ratified?
4. What are the possible implications of a claim brought by an investor?
5. What are the main features in managing an investment dispute?

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MODULE 4

Interaction between IIAs and other areas

INTRODUCTION TO MODULE 4

Foreign investment may be affected by issues that are not traditionally included in IIAs. These issues are usually regulated by international agreements or national laws. They are of different types and can be classified as follows:

(a) Issues that are directly concerned with the definition of foreign investment

Services. The WTO General Agreement on Trade in Services is perhaps the most significant internationally agreed upon text on this issue. Within the context of a general liberalization trend, this agreement sets international parameters for national policies on services. They interact with FDI provisions to the extent that a service is rendered through a commercial presence in the host country (FDI in services).

State contracts. A common mode of entry for foreign investors is through the making of an investment contract with the State or a State entity. Accordingly, regulation of State contracts is of relevance to IIAs, as it often forms the legal basis of the relationship between a foreign investor and a host country.

Intellectual property rights. In the context of IIAs, IPRs have played a central role, as these rights are considered a type of investment. However, the recognition of IPRs as FDI depends on the scope of the definition of investment. Currently, investment definitions in most IIAs include all kinds of intellectual property rights.

(b) Issues that affect investment performance

Competition. Competition policy deals with the regulation of certain types of anticompetitive practices conducted by privately owned and operated undertakings. Competition law and policies are particularly important in the context of FDI, because host countries need to ensure that the reduction of regulatory barriers to FDI and the strengthening of standards of treatment of foreign investors are not accompanied by the emergence of private barriers to entry and anticompetitive behaviour of firms. Competition issues are usually dealt with in a specialized instrument rather than a general IIA.

Technology transfer. Transfer of technology to developing countries has been one of the most discussed areas of international economic relations in the past thirty or more years. As a result, many developing countries have implemented policy initiatives and adopted a significant number of legal provisions both in national law and in international instruments that seek to regulate it. In the present context, the design of policies must rely on an understanding of the technology development process, the role of TNCs in this process, and their interactions with local learning.

Corporate governance. The internationalization of cross-border portfolios and the financial crises that have occurred in several countries have triggered the necessity to improve the integrity, transparency and accountability of corporations. In this context, the degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions. If countries are to reap the full benefits of the global capital market, and if they are to attract long-term capital, corporate governance arrangements must be credible, well understood across borders and adhere to internationally accepted principles.

(c) Issues that are increasingly included in recent IIAs

Employment. Although labour issues are relatively uncommon in IIAs, they have appeared in recent IIAs in order to avoid the relaxation of labour standards as a strategy to attract foreign direct investment (social dumping).

Environment. Environmental issues cover a broad scope of activities and are dealt with in a wide spectrum of instruments beyond those specific to FDI. Provisions in IIAs concerning environmental issues, mainly seek to avoid the relaxation of environmental standards as a strategy to attract FDI.

THEME 1
Investment and services

INTRODUCTION

Over the past decade, the number of international agreements covering services has increased substantially, both in number and in geographical scope. The WTO General Agreement on Trade in Services is perhaps the most significant internationally agreed upon set of rules on this issue. Within the context of a broad liberalization trend, these agreements increasingly set the parameters for national policies on services through interaction between national and international policies on foreign direct investments in services. This interaction can either be led by autonomous liberalization or driven by IIAs. However, this complex and dynamic interaction raises challenges for development. While IIAs and autonomous liberalization create an enabling framework for FDI, the former also limit national policy space. In this context, the question has been raised how to best achieve development goals and how to strengthen the development dimension of IIAs.

At the end of this theme, students should be able to:

- Understand the interaction between trade in services and investments;
- Identify main features of trade in services; and
- Identify and distinguish between various mechanisms to regulate services in IIAs.

HANDBOOK

1 Explanation of the issue

Services can be defined as activities that add value either directly to another person or to a good belonging to another person[50] (also refer to Module 1, theme 4).

Services possess two main characteristics that make them very different from goods:

- They are intangible;
- They are non-storable.

The WTO General Agreement on Trade in Services (Art. 1a) presents an internationally agreed upon set of rules on the issue. The agreement as a whole has six parts. An opening section sets out the scope and definition of the agreement. Part II, the longest section, deals with general obligations and disciplines, that is, with rules that apply, for the most part, to all services and all members. Part III sets out rules governing the specific commitments in schedules. Part IV concerns future negotiations and the schedules themselves. Parts V and VI cover institutional and final provisions.

The agreement applies to **measures by WTO members that affect trade in services** (GATS Art. 1a). All services are covered, except those "supplied in the exercise of governmental authority", these being defined as services which are neither supplied on a commercial basis nor in competition with other service suppliers.[51] Examples for such kinds of services are central banking and social security.

Article I sets out a comprehensive definition of trade in services in terms of four different **modes of supply**: cross-border, consumption abroad, commercial presence in the consuming country, and presence of natural persons.[52]

[50] See Warren (1995: 2).

[51] *Ibid.*, Article I:3(b) and (c), and Annex on Financial Services, 1(b).

[52] *Ibid.*, Article I:2.

Box 111

GATS definition of trade in services

Article I: Scope and Definition

2. For the purposes of this agreement, trade in services is defined as the supply of a service:
(a) from the territory of one member into the territory of any other member;
(b) in the territory of one member to the service consumer of any other member;
(c) by a service supplier of one member, through commercial presence in the territory of any other member;
(d) by a service supplier of one member, through presence of natural persons of a member in the territory of any other member. (...)

This definition is of crucial importance because it has shaped the principles and rules embodied in the GATS and has determined the different modes of services supply.

Commercial presence (mode 3) is important in the context of IIAs because it also implies an investment in the territory where the service will be supplied.

Box 112

Modes of services supply

Mode 1: Cross-Border Supply of Services
Only the service itself crosses national frontiers. Buyer and seller do not cross national frontiers.

Mode 2: Consumption Abroad
This concerns the consumer travelling to the supply country. Only the buyer crosses national frontiers.

Mode 3: Commercial Presence
The supply of a service through the commercial presence of the foreign supplier in the territory of another member. This mode commonly requires a foreign direct investment.

Mode 4: Presence of Natural Persons
Admission of foreign nationals to another country to provide services there.

2 Services and IIAs

Over the past decade, the number of regional trade agreements covering both services and foreign investments has increased considerably. The result is a network of international rules, with obligations differing in scope and content.

Within the context of a broad liberalization trend, these agreements increasingly set the parameters for national policies on services through interaction between national and international rules on FDI in services. This interaction can either be led by autonomous liberalization or driven by IIAs.

Most RTAs, however, have treated investment in services as conceptually different from investment in other sectors. Accordingly, FDI is exclusively covered by the disciplines of the investment chapter of an agreement, or where an agreement deals exclusively with investment. In both cases, the agreement or the specific chapter covers services and non-services investments without differentiating between them.

Box 113

Example: NAFTA – FDI and services treatment

Chapter Eleven: Investment
Article 1101: Scope and Coverage
1. This chapter applies to measures adopted or maintained by a party relating to:

(a) investors of another party;
(b) investments of investors of another party in the territory of the arty; and
(c) with respect to Articles 1106 and 1114, all investments in the territory of the party.

Article 1112: Relation to Other Chapters
1. In the event of any inconsistency between this chapter and another chapter, the other chapter shall prevail to the extent of the inconsistency.

2. A requirement by a party that a service provider of another party post a bond or other form of financial security as a condition of providing a service into its territory does not of itself make this chapter applicable to the provision of that cross border service. This chapter applies to that party's treatment of the posted bond or financial security.

Chapter Twelve: Cross-Border Trade in Services
Article 1201: Scope and Coverage
1. This chapter applies to measures adopted or maintained by a party relating to cross-border trade in services by service providers of another Party, including measures respecting:

(d) the presence in its territory of a service provider of another party; and
(e) the provision of a bond or other form of financial security as a condition for the provision of a service.

This complex and dynamic interaction poses challenges for development. While IIAs and autonomous liberalization create an enabling framework for FDI, the former also limit national policy space. And so the question has come up regarding how to best achieve development goals and how to strengthen the development dimension of IIAs.

Services regulation in the context of RTAs has solved this question in two different ways (refer also to Module 3, theme 2):

Negative list approach. Under this approach the liberalization of trade in services is based on a "top down" approach or a "negative list" approach. This means that services are to be free of restraints for all sectors unless specified otherwise in the list of exceptions. Accordingly, trade in services does not require the negotiation of schedules of commitments since liberalization is to be guaranteed for all sectors and for all service suppliers under unrestricted provisions on most-favoured-nation and national treatment. NAFTA and "NAFTA-type" agreements have followed this approach.

Positive list approach. Under this concept the liberalization of trade in services is based on a "bottom up" approach, or "positive list" approach, that follows the GATS model. Liberalization is not comprehensive and automatic. It is subject to commitments concerning market access and national treatment in specifically designated sectors. Such commitments are laid down in individual country schedules whose scope may vary widely between members. Each party is free to tailor the sector coverage and substantive content of such commitments. The commitments thus tend to reflect national policy objectives and constraints, overall as well as in individual sectors. The existence of specific commitments triggers further obligations concerning, *inter alia*, the notification of new measures that have a significant impact on trade and the avoidance of restrictions on international payments and transfers. The MERCOSUR Protocol on Trade in Services is a good example of this approach.

On the other hand, the complex network of IIAs also raises questions concerning the coexistence of multilateral, regional and bilateral IIAs covering services. There is, indeed, a need to ensure that rules are consistent with each other and that they complement each other in a mutually supportive way. The challenge is to create consistency while on one hand different international treaty obligations accepted by contracting parties, and on the other hand national legal and policy changes made in the process of implementing international obligations. To avoid the adoption of inconsistent international obligations, a number of services IIAs mirror the provisions of the GATS, incorporating – by reference – existing or future GATS obligations or, more broadly, affirm they are complementarity with the GATS regime.

Exercises and questions for discussion

1. Give examples for each of the four modes of supply.
2. Explain the interaction between services and foreign investments.
3. What are the advantages and disadvantages of the "positive list" and "negative list" approach in the area of trade in services?

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Theme 2
Investment and State contracts

INTRODUCTION

A common mode of entry for investors into a foreign market is through the conclusion of a foreign investment contract with the State or State entity. Hence, regulation of State contracts is of relevance to international investment agreements as it often forms the legal basis of the investment relationship between a foreign investor and a host country. Indeed, State contracts can be seen as part of a multiplicity of legal norms that affect the conduct of a host country's FDI policy and, by extension, its relationships with individual investors. These contracts usually contain provisions on the admission of establishment of the investment and its post-establishment treatment (refer to Module 3, theme 2).

At the end of this theme, students should be able to:

- Understand the interaction between State contracts and foreign investments;
- Identify main features of State contracts; and
- Identify and distinguish between various approaches regarding State contracts regulation in IIAs.

HANDBOOK

1 Explanation of the issue

The conclusion of a foreign investment contract with the State or State entity constitutes a common mode of entry for investors into a foreign market.

Box 114

Definition of State contract

A State contract can be defined as a contract made between the State or an entity of the State[53] and a foreign national or a legal person of foreign nationality.

[53] For present purposes, an entity of the State may be defined as any organization created by statute within a State and that is given control over an economic activity.

State contracts can cover a wide range of issues, including loan agreements, purchase contracts for supplies or services, contracts of employment, or large infrastructure projects and resource exploitation, commonly realized through concession agreements.

As most of these sectors are of economic relevance to domestic economies, it has been universally recognised that State contracts are quite different from ordinary commercial contracts as they cover State interests and may involve large parts of a State's financial and other resources.

Accordingly, most domestic systems apply special regulations to the process of negotiation, conclusion, operation or termination of State contracts. However, the approach varies according to the national system of law. Most domestic legal systems – for example the French administrative law – treat State contracts as a special category of contract (contrat administratif) which is subject to a specialized regulatory regime. In common law countries, public law considerations have been introduced into general principles of the common law of contract to cover government contracts.

State contracts main features can be summarised as follows:

- The capacity of a State entity to make contracts is subject to special rules that are commonly stated in the legislation creating it. The national law may also identify areas in which the State entity has the capacity to conclude contracts.

- Signing a contract may be subject to specific requirements, and there may be other specific procedures for review and scrutiny of the contract.

- Domestic legal systems normally put restraints on the manner in which public funds are spent and received, and subject such matters to careful scrutiny through regulatory laws.

- The source of the law applicable to the contract is usually to be found in statutes and regulations on the subject matter of the contract as well as on the State entity concluding the contract.

- Operation in sectors, such as the petroleum sector, is open only to a State entity or in association with a State entity. Thus, entry into such a sector by other investors is possible only through the conclusion of a contract with the relevant State entity.

- The termination of a State contract may depend on conceptions of public need. This may attract rules for determining damages that are not entirely based on commercial considerations that may apply to ordinary contracts.

- The means of termination may also differ between ordinary commercial contracts and State contracts. While both may be terminated by breaches, State contracts may be terminated, or their performance made wholly or partially impossible, by State action. Under several theories of domestic law, the power of the legislature may not be restricted by the existence of contractual commitments, although as a rule compensation may be owed under constitutional protections.

As a result of such special regulations, the balance of rights and obligations under State contracts may favour the governmental party. This balance can expose the private contracting party to the risk of interference with the commercial expectations that have induced the latter into the contract. It is this commercial risk that has motivated the development of rules of customary international law on State responsibility for breaches of State contracts.

2 State contracts and IIAs

Regarding foreign investments under the form of State contracts it is important to differentiate between those norms that govern the conditions for the validity of a State contract, including such matters as the capacity of the parties and the process of formation and termination of a contract, and those provisions that govern investment covered by State contracts.

Under the traditional viewpoint, the domestic law of each host country governs the conditions for the validity of a State contract, including such matters as the capacity of the parties and the process of formation of a contract. However, some cases – for example, the case of petroleum contracts – have been regarded as "economic development agreements", which should be subject to international legal norms through the use of certain clauses that may have the effect of internationalizing the contract. The theory of internationalization of contracts states that obligations arising from a contract may reside in the transnational law of business, in general principles of law or the lex mercatoria. The main reason for the "internationalization" of State contracts is the concern over the impartiality of domestic courts and the objective to neutralize the built-in superiority of host country institutions because of their sovereign powers of legislation abrogating or interfering with contracts.

IIAs, on the contrary, are generally not designed to protect an individual contract, which is left to the negotiation of the parties. They are meant to ensure the stability of the operating structure of the investment within the host country (which may include investments covered by State contracts). Accordingly, IIAs do not necessarily deal directly with State contracts

The issue of State contracts, as it relates to IIAs, concerns the extension of IIAs' protection to State contracts, which depends on the scope of the definition of investment and to what extent dispute settlement provisions of the agreements apply.

2.1 Definition of State contracts in IIAs

The extent to which IIAs cover State contracts depends first of all on the scope of the definition of investment provided for in an agreement (refer to Module 3, theme 2).

Box 115

Definitions of investment including State contracts

BIT USA – Ecuador, 1993
Article I:
1. For the purposes of this treaty, "investment" means every kind of investment in the territory of one party owned or controlled directly or indirectly by nationals or companies of the other party, such as equity, debt, and service and investment contracts; and includes: (...) (v) any right conferred by law or contract, and any licenses and permits pursuant to law;

BIT China – Germany, 2003
Article 1 – Definitions:
For the purpose of this Agreement, the term "investment" means every kind of asset invested directly or indirectly by investors of one contracting Party in the territory of the other contracting party, and in particular, though not exclusively, includes: (...) (e) business concessions conferred by law or under contract permitted by law, including concessions to search for, cultivate, extract or exploit natural resources; (...).

The concession agreements that are usually referred to in these provisions are a variety of State contracts. The purpose of their inclusion is usually to ensure that agreements in the natural resources industries come within the scope of the definition of investments. Petroleum and natural resources contracts played a dominant role in the development of this area of the law and continue to receive attention because of the amount of investment that takes place in the sector.

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

Box 116

Definition of investment including contractual rights

USA BIT model, 2004
Article 1: (...) "investment" means every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk. Forms that an investment may take include: turnkey, construction, management, production, concession, revenue-sharing, and other similar contracts; licenses, authorizations, permits, and similar rights conferred pursuant to applicable domestic law.[54,55]

[54] Whether a particular type of license, authorization, permit, or similar instrument (including a concession, to the extent that it has the nature of such an instrument) has the characteristics of an investment, depends on such factors as the nature and extent of the rights that the holder has under the domestic law of the party. Among the licenses, authorizations, permits, and similar instruments that do not have the characteristics of an investment are those that do not create any rights protected under domestic law. For greater certainty, the foregoing is without prejudice to whether any asset associated with the license, authorization, permit, or similar instrument has the characteristics of an investment.

[55] The term "investment" does not include an order or judgment entered in a judicial or administrative action.

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

2.2 Dispute settlement provisions

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

Indeed there are general provisions in some IIAs that refer to the protection of obligations undertaken towards the nationals of other parties. Such clauses have been referred to as "umbrella clauses".

Box 117

Umbrella clauses

Most European model BITs, should they include such a clause, do so within the article on promotion and protection of investment. The clause usually reads as follows:

"Each contracting party shall observe any obligation it may have entered into with regard to investments of nationals or companies of the other contracting party"

(1991 United Kingdom model BIT, Article 2(2); see also 2000 Denmark BIT model, Article 2.3, and the 2002 Sweden BIT model, Article 2(4)). The Swedish model is notable for the fact that the umbrella clause is combined with the full protection and security standard.

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

"1. If the legislation of either contracting State or obligations under international law [...] contain a regulation [...] entitling investments by investors of the other contracting State to a treatment more favourable than is provided for by this Treaty, such regulation shall to the extent that it is more favourable prevail over this Treaty.

2. Each contracting State shall observe any other obligation it has assumed with regard to investments in its territory by investors of the other contracting State."

However, there is some uncertainty as to the precise nature and effect of these clauses. This issue has generated some recent case law. In particular, two recent arbitral decisions brought by the Swiss-based transnational corporation *Société Générale de Surveillance* (SGS) against Pakistan and the Philippines have attempted, without much success, to clarify the extent to which an investor's claim against a host country government for breach of contract can be elevated to a claim under a BIT by relying on an umbrella clause in a BIT between the investor's home country and the host country.

In each case, the central question was whether, through the umbrella clause in the applicable BIT, the investor's contractual claims against the host country (for breaches of contracts entered into for the provision of pre-shipment customs inspection services) could be resolved under the arbitration provisions of the BIT, rather than under the dispute resolution provisions of the contract under dispute.

Box 118

Umbrella clauses interpretation

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

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

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

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

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

2. The arbitral tribunal in **SGS versus the Philippines** returned to the question of the effect of an umbrella clause. While the contract between SGS and the Philippines provided that the courts of the Philippines would have exclusive jurisdiction over disputes under the contract, SGS commenced ICSID arbitration proceedings on the ground that its contract claim could be elevated to a treaty claim under the umbrella clause of the BIT between the Philippines and Switzerland.

In this case, the tribunal (not being bound by a strict doctrine of precedent) interpreted the umbrella clause in a way diametrically opposed to the interpretation adopted by the previous tribunal. It held that the umbrella clause did, in principle, have the effect of conferring jurisdiction on an arbitration tribunal constituted under the BIT to determine purely contractual claims between an investor and the host State. The tribunal disagreed that the umbrella clause was merely a "second order" protection, instead preferring the view that the clause "means what it says".

However, the tribunal held that even though it had jurisdiction under the BIT to arbitrate purely contractual claims, it would not exercise such jurisdiction in the case at hand since the parties had agreed to submit their contractual disputes to the exclusive jurisdiction of the Philippines courts. The investor should not commence arbitration based on the host country's breach of contract if arbitrating the dispute would not be in compliance with the dispute resolution provision of the same agreement. Consequently, the tribunal stayed its own proceedings in favour of the Philippines courts.

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

Exercises and questions for discussion

1. Explain the concept of State contracts and its main characteristics.
2. Explain the interaction between State contracts and foreign investments.
3. What are the policy implications of the regulation of State contracts in IIAs?
4. What is an umbrella clause? Explain the meaning of the umbrella clause in the context of dispute settlement.

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THEME 3
Investment and intellectual property rights

INTRODUCTION

In the context of IIAs, intellectual property rights play a central role, insofar as these rights are considered as a type of investment. They can be of crucial importance to foreign investors, since they may constitute a competitive advantage *vis-à-vis* other firms. However, the recognition of IPRs as FDI depends on the scope of the definition of investment. Currently, investment definitions in most IIAs include all kinds of intellectual property rights.

IPRs are the rights given to persons over their intellectual property, that is, the expressed form of an idea or other intangible subject matter. This reflects the conviction that the product of the mind or the intellect shall be protected by law equally as any other form of property. IPRs consequently give the creator an exclusive right over the use of his/her creation for a certain period of time.

At the end of this theme, students should be able to:

- Understand the interaction between intellectual property rights and foreign investments;
- Identify main types of intellectual property rights; and
- Identify and analyse different approaches of intellectual property rights definitions in IIAs.

HANDBOOK

1 Explanation of the issue

IPRs include foremost inventions, literary and artistic works, symbols, names, images, and designs used in commerce. They give the creator usually an exclusive right over the use of his/her creation for a certain period of time.

Intellectual property can be divided into two broad categories:

- **Industrial property**, which includes inventions (patents), trademarks, industrial designs, and geographical indications /indications of origin.

- **Copyright**, which includes literary and artistic works such as novels, poems, plays, films, musical works; and drawings, paintings, photographs, sculptures and architectural designs.

1.1 Industrial property

1.1.1 Patents

A patent is an exclusive right granted for an invention, which is a product or a process that provides, in general, a new way of doing something, or offers a new technical solution to a problem.

In order to be patentable, the invention must fulfil certain conditions:

- It must be of practical use;
- It must show an element of novelty, that is, a new characteristic not yet known in its technical field (prior art);
- The invention must show an inventive step, which could not be deduced by a person with an average knowledge in the technical field;
- Its subject matter must be accepted as "patentable" under law. In many countries, scientific theories, mathematical methods, plant or animal varieties, discoveries of natural substances, commercial methods, or methods for medical treatment (as opposed to medical products) are generally not patentable.

A patent provides protection for the invention to the owner of the patent. The protection is granted for a limited period of time, generally 20 years.

1.1.2 Trademarks

A trademark is a distinctive sign, which identifies certain goods or services as those produced or provided by a specific person or enterprise. Trademarks may be a combination of words, letters, and numerals. They may consist of drawings, symbols, three-dimensional signs such as the shape and packaging of goods, audible signs such as music or vocal sounds, fragrances, or colours used as distinguishing features.

A trademark provides protection to the owner of the mark by ensuring the exclusive right to use it to identify goods or services, or to authorize another to use it in return for payment. The system helps consumers identify and purchase a product or service because its nature and quality, indicated by its unique trademark, meets their needs. Trademark protection also hinders the efforts of unfair competitors, such as counterfeiters, to use similar distinctive signs to market inferior or different products or services. The system enables people with skill and enterprise to produce and market goods and services in the fairest possible conditions, thereby facilitating international trade.

The period of protection varies, but a trademark can be renewed indefinitely beyond the time limit on payment of additional fees.

1.1.3 Industrial designs

Industrial designs are what make an article attractive and appealing; hence, they add to the commercial value of a product and increase its marketability. The design may consist of three-dimensional features, such as the shape or surface of an article, or of two-dimensional features, such as patterns, lines or colour.

To be protected under most national laws, an industrial design must appeal to the eye. This means that an industrial design is primarily of an aesthetic nature, and does not protect any technical features of the article to which it is applied.

When an industrial design is protected, the owner – the person or entity that has registered the design – is assured an exclusive right against unauthorized copying or imitation of the design by third parties. This helps to ensure a fair return on investment. An effective system of protection also benefits consumers and the public at large, by promoting fair competition and honest trade practices, encouraging creativity, and promoting more aesthetically attractive products.

In most countries, an industrial design must be registered in order to be protected under industrial design law. As a general rule, to be eligible for registration, the design must be "new" or "original". Once a design is registered, a registration certificate is issued. Following that, the term of protection is generally five years, with the possibility of further periods of renewal up to, in most cases, 15 years.

1.1.4 Geographical indications

A geographical indication is a sign used on goods that have a specific geographical origin and possess qualities or a reputation that are due to that place of origin. It points to a specific place or region of production that determines the characteristics of the product that originates therein. It is important that the product derives its qualities and reputation from that place. Since those qualities depend on the place of production, a specific "link" exists between the products and their original place of production.

Most commonly, a geographical indication consists of the name of the place of origin of the goods. They may be used for a wide variety of agricultural products, such as, for example, "Tuscany" for olive oil produced in a specific area of Italy (protected, for example, in Italy by Law No. 169 of February 5, 1992), or "Roquefort" for cheese produced in France (protected, for example, in the European Union under Regulation (EC) No. 2081/92 and in the US under US Certification Registration Mark No. 571.798).

1.2 Copyright and related rights

Copyright is a legal term describing rights given to creators for their literary and artistic works. Creators include:

- Performing artists such as actors and musicians in their performances;
- Producers of sound recordings for example, cassette recordings and compact discs in their recordings;
- Broadcasting organizations in their radio and television programs.

Copyrights give to the original creators of works two different rights: economic and moral rights.

1.2.1 Economic rights

Economic rights are those payments that the creators of a work receive when they sell the rights to their work to individuals or companies best able to market the work (for example, publications, sound recordings and films). These payments are often made dependent on the actual use of the work, and are then referred to as royalties.

Economic rights commonly have a time limit of 50 years after the creator's death. This limit enables both creators and their heirs to benefit financially for a reasonable period of time.

1.2.2 Moral rights

Moral rights involve the right to claim authorship of a work, and the right to oppose changes to it that could harm the creator's reputation. The creator of a work can prohibit or authorize:

- Its reproduction in various forms, such as printed publication or sound recording;
- Its public performance, as in a play or musical work;
- recordings of it, for example, in the form of compact discs, cassettes or videotapes;
- Its broadcasting, by radio, cable or satellite;
- Its translation into other languages, or its adaptation, such as a novel into a screenplay.

2 Intellectual property rights and IIAs

Whether IPR protection is an important determinant in the local competition for foreign direct investments is still unsettled. Theoretical reasoning and empirical investigations point to an ambiguous relationship between IPR protection and the distribution of FDI across countries.

However, multinational enterprises are reluctant to engage in countries where an unauthorized use of such assets by outsiders is not prevented. The attempt of policymakers to lure FDI by all possible means may have contributed to the strengthening of IPR protection, especially since the early 1990s. The conclusion of the Agreement on Trade-Related Intellectual Property Rights, which emerged from the Uruguay Round, represents one of the pillars of this trend.

In the context of IIAs, IPRs also have played a central role, as these rights are considered a type of investment. However, the recognition of IPRs as FDI depends on the scope of the definition of investment (refer to Module 3, theme 2). Investment definitions in most IIAs commonly include a broad range of IPRs.

Box 119

Definition of investment that include IPRs – Examples

BIT France – Malta, 1976

Article 1: For the purposes of this Agreement:

(1) The term "investment" means property of every kind and more particularly but not exclusively: (...)

(d) copyrights, industrial property rights, technical processes, trademarks and goodwill; (...)

USA BIT model, 2004

Article 1: Definitions

"investment" means every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk. Forms that an investment may take include:

(f) intellectual property rights

Definition and extension of IPRs included in IIAs depends on domestic laws. However, the extent of protection and enforcement of these rights vary widely around the world and these differences may become a source of tension in international economic relations.

Internationally agreed upon rules for intellectual property rights seek to harmonize existing legal regimes and to avoid these tensions. WTO TRIPS Agreement, for example, is an attempt to bring intellectual property rights under common international rules. It establishes minimum levels of protection that each government has to give to the intellectual property of fellow WTO members. The TRIPs Agreement contains a set of minimum standards for IPR protection and requires all member countries to apply the most-favoured-nation principle to IPR protection. The agreement covers five broad issues:

- How basic principles of the trading system and other international intellectual property agreements should be applied;
- How to give adequate protection to intellectual property rights;
- How countries should enforce those rights adequately in their own territories;
- How to settle disputes on intellectual property between members of the WTO;
- Special transitional arrangements during the period when the new system is being introduced.

Exercises and questions for discussion

1. Cite and explain the different types of intellectual property rights.
2. Explain the effects of the protection of intellectual property on the investment location.
3. How is the issue of intellectual property treated in IIAs?

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THEME 4
Investment and competition

INTRODUCTION

Competition policy deals with the regulation of certain types of anticompetitive practices conducted by privately owned and operated undertakings. These are often referred to in international instruments as restrictive business practices. Competition law and policy are particularly important in the context of FDI, because host countries have to ensure that the reduction of regulatory barriers to FDI and the strengthening of standards for the treatment of foreign investors are not accompanied by the emergence of private barriers to entry and anticompetitive behaviour of firms. There is the risk that foreign investors may drive domestic enterprises out of the market or that they may adversely affect domestic prices. Given their complexity, competition issues are usually dealt with in a specialized instrument rather than in a general IIA.

At the end of this theme, students should be able to:

- Understand the interaction between competition and foreign investments;
- Identify main features of competition; and
- Identify and analyse different approaches of competition regulation in IIAs.

HANDBOOK

1 Explanation of the issue

The different types of anticompetitive practices in RBPs are:

- Collusion between firms;
- Abuse of a dominant position;
- Anti-competitive mergers and acquisitions.

1.1 Collusion between firms

Competition law distinguishes between economic arrangements among competing firms on the same level **(horizontal collusion)** and arrangements among firms (suppliers and/or producers and/or distributors) on different distributional levels **(vertical collusion)**. Collusion between firms can lead to distortions of market conditions.

1.1.1 Horizontal collusion

Collusion between competitors may replace the market-based allocation of resources. If the determination of market prices is manipulated by a concerted action of private actors (suppliers, producers and/or distributors) this may undermine the capacity of the market to regulate essential economic activities. This phenomenon is regularly referred to as cartelization of the market.

Box 120

Examples of horizontal collusion

- **Concerted price fixing;**
- **Market sharing arrangements;**
- **Agreed production quotas;**
- **Cooperation agreements.**

However, not all cooperative activities between competitors are necessarily detrimental to the consumer. Thus, for example, joint ventures that may lead to the development of new products or technologies may be positively encouraged. Likewise, in cases of serious economic instability, cooperative restructuring arrangements between producers may be permissible.

1.1.2 Vertical collusion

Like horizontal collusion among competitors, vertical collusion between suppliers, producers and/or distributors, may replace the market-based allocation of resources and the determination of prices by concerted action of private actors. This may undermine the capacity of the market to regulate these essential economic activities.

Antitrust law distinguishes between:

- Vertical price fixing: Agreements, whereby a seller and a buyer agree with respect to the price at which the buyer will resell.

- Non-Price vertical restraints: Agreements that seek to restrain intra-brand competition in the seller's goods among the various dealers in order to enhance the goods' position in the inter-brand competitive struggle with the goods of other sellers, such as exclusive selling agreements, territorial and customer restrictions, exclusive dealing agreement and tying arrangements.

However, vertical cooperation between firms is generally regarded as being less serious than horizontal cooperation as long as the market shares of the participants are relatively small, and the market is not highly concentrated among a small number of firms each operating a restrictive network of vertical arrangements for supply and/or distribution.

1.2 Abuse of a dominant position

Rules against the abuse of a dominant position – or **monopolization** of the market – seek to regulate anti-competitive behaviour carried out by a single economic undertaking that enjoys a dominant position on the market in question, or by more than one undertaking in such a position. Here, the reality of the market power of the undertaking allows it to act without taking into consideration the activities of its nearest rivals, suppliers or distributors, and to ignore the interests of consumers.

Box 121

Examples of abuse of a dominant position

- **Monopolistic price rises – consumers have to bear it in the absence of alternative suppliers;**
- **The imposition of unfair or discriminatory commercial terms upon suppliers and/or distributors;**
- **The use of predatory pricing to oust new entrants onto the market;**
- **Boycotts of firms that do not comply with the dominant firm's restrictive terms of doing business;**
- **The exclusive use of an essential commercial facility;**
- **Control over essential technologies or resources needed by competitors.**

However, it should be stressed that the mere possession of dominant market power is not in itself the mischief that competition policy seeks to control; rather it is the abuse of that power to achieve anti-competitive aims that is the object of regulation.

An abuse of a dominant position is established as follows:

- A dominant position must first be shown, either within the market as a whole or a substantial part of it;
- Second, an abuse of the dominant position needs to be established.

1.3 Anti-competitive mergers and acquisitions

The control of M&As seeks to limit, as far as it may be foreseen, the creation of a dominant position that may lead to anti-competitive abuses, on the part of the merging undertakings, or as a result of the acquisition of one undertaking by another.

This process requires an economic analysis of the existing market structure and its comparison with the structure that would result after the merger or acquisition takes place. If the degree of projected concentration of the market reaches a level in which a dominant position is acquired, the merger or acquisition may have to be modified in accordance with the conditions placed upon it by the regulatory authority, or it may be barred outright.

2 Competition and IIAs

Competition issues are usually dealt with in a specialized instrument rather than in a general IIA. At the multilateral level, the only instrument that covers all aspects of competition regulation is the 1980 United Nations Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices. Competition provisions can also be found in international agreements, such as regional agreements and free trade agreements, or in specific provisions cooperation agreements in the field of competition.

The main interaction between investment and competition provisions in international agreements can be found in two main fields:

- First, there are measures seeking to create a common substantive and procedural system of competition regulation between the contracting parties. This approach was pioneered by the European Union, which established the first supranational competition regime. More recently, other regional groupings, including developing country groupings, have instituted common competition practices and institutions. In the Andean Community, for example, Decision 285 is applicable when the restrictive practices originate in the subregion or when a company that carries out its economic activities in a member country is involved.[56] However, no one has yet developed a fully supranational system, comparable to the system of the EU.

- Secondly, provisions in international agreements can introduce a measure of substantive harmonization into the national competition policies of the members to this agreement.

[56] Subregional origin exists when the practices are carried out by enterprises whose economic activities are performed in one or more member countries. Involvement occurs when the practice is carried out between enterprises whose activities are performed in one or more ,member countries and companies located outside the subregion.

Box 122

Competition provisions in FTA Canada – Chile

Article J-01: Competition law

1. Each party shall adopt or maintain measures to proscribe anti-competitive business conduct and take appropriate action with respect thereto; recognizing that such measures will enhance the fulfilment of the objectives of this Agreement. To this end the parties shall consult from time to time about the effectiveness of measures undertaken by each party.

2. Each party recognizes the importance of cooperation and coordination among their authorities to further effective competition law enforcement in the free trade area. The parties shall cooperate on issues of competition law enforcement policy, including mutual legal assistance, notification, consultation and exchange of information relating to the enforcement of competition laws and policies in the free trade area.

3. Neither party may have recourse to dispute settlement under this agreement for any matter arising under this article.

Exercises and questions for discussion

1. Explain the interaction between competition and foreign investments.
2. Explain the different approaches in IIAs regarding the regulation of competition.
3. Imagine that an IIA includes a right of establishment for foreign investors. Would the country concerned have to admit a foreign investor, although he/she acquires a dominant market position?

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Theme 5
Investment and technology transfer

INTRODUCTION

One of the most important contributions that host developing countries seek from foreign investments in their economies is technology. Technology is key to economic progress and critical for development. It also facilitates international economic integration.

At the end of this theme, students should be able to:

- Understand the interaction between technology transfer and foreign investments;
- Identify main concepts regarding technology transfer;
- Understand and analyse main features of technology transfer issues; and
- Identify and analyse the different mechanisms implemented in IIAs in order to promote technology transfer.

HANDBOOK

1 Explanation of the issue

Any discussion of investment by TNCs and technology needs a sound understanding of what is actually meant by the terms technology, technology transfer and technology diffusion.

1.1 Technology

A comprehensive definition of technology must encompass all forms of commercially usable knowledge, whether patented or unpatented, which can form the subject matter of a transfer transaction.

Box 123

Definition of technology

UNCTAD draft International Code on the Transfer of Technology defines technology as: "systematic knowledge for the manufacture of a product, for the application of a process or for the rendering of a service", which does not extend to the transactions involving the mere sale or mere lease of goods".

This definition clearly excludes goods that are sold or hired from the ambit of "technology". Thus it is the knowledge that goes into the creation and provision of the product or service that constitutes "technology", not the finished product or service as such.

Such knowledge should be seen as encompassing both the technical knowledge on which the end product is based, and the organizational capacity to convert the relevant productive inputs into the finished item or service, as the case may be.

Consequently, "technology" includes not only "knowledge or methods that are necessary to carry on or to improve existing production and distribution of goods and services" or indeed to develop entire new products or processes, but also "entrepreneurial expertise and professional know-how" (Santikarn, 1981: 4).

The latter two elements may often prove to be the essential competitive advantage possessed by the technology owner.

1.2 Technology transfer

Technology transfer is the process by which commercial technology is disseminated. This takes the form of a technology transfer transaction, which may or may not be covered by a legally binding contract (Blakeney, 1989: 136), but which involves communication of relevant knowledge from the transferor to the recipient.

Box 124

Types of transfer transactions

UNCTAD draft International Code on the Transfer of Technology has listed the following types of transfer transactions:
(a) The assignment, sale and licensing of all forms of industrial property, except for trade marks, service marks and trade names when they are not part of transfer of technology transactions;
(b) The provision of know-how and technical expertise in the form of feasibility studies, plans, diagrams, models, instructions, guides, formulae, basic or detailed engineering designs, specifications and equipment for training, services involving technical advisory and managerial personnel, and personnel training;
(c) The provision of technological knowledge necessary for the installation, operation and functioning of plant and equipment, and turnkey projects;
(d) The provision of technological knowledge necessary to acquire, install and use machinery, equipment, intermediate goods and/or raw materials which have been acquired by purchase, lease or other means;
(e) The provision of technological contents of industrial and technical cooperation arrangements.

The list excludes non-commercial technology transfers, such as those found in international cooperation agreements between developed and developing countries. Such agreements may relate to infrastructure or agricultural development, or to international cooperation in the fields of research, education, employment or transport.

1.3 Technology diffusion

The use of new technology by a recipient is only one of the benefits that the recipient's economy obtains from that technology. Another, often larger, benefit is the diffusion of technology and skills within the host economy.

Technology transfer should be distinguished from technology diffusion. The latter can be achieved by the fact that the introduction of a technology into a host country creates an awareness of that technology. That awareness may spill over into the economy as a whole. This may occur without any deliberate intent, simply through the passage of time, or it may occur as a result of deliberate policies on the part of the host country, such as training requirements for local personnel or the compulsory licensing of technology to local firms, or as a result of TNC strategy in the form of purchase of inputs – components and services from local firms – requiring the latter to become familiar with the technology involved so as to be able to perform the functions required by the TNC.

Many forms of diffusion are not priced or paid for in markets. They are externalities that arise involuntarily or are deliberately undertaken to overcome information problems. Thus, in response to the presence of TNCs, local firms and industries may become linked into the technological processes of those firms through "demonstration effects", as when domestic firms seek to imitate the technology applied by TNCs, and to compete with TNCs by improving their technological capabilities and raising productivity. Even more importantly, diffusion can occur through cooperation between foreign affiliates, domestic suppliers and customers, leading to technology transfer to vertically linked firms and service providers. Furthermore, labour mobility from foreign affiliates to domestic firms, particularly of highly skilled personnel, can stimulate technological development.

On the other hand, such spillover effects may not be inevitable, as where a TNC closely guards its competitive advantage in its technology, whether through its retention within the TNC network, and/or through limited skills transfer to employees and/or through restrictive terms in employee contracts, preventing them from revealing technical secrets or from working for direct competitors for a set period of time.

2 Technology transfer and IIAs

Transfer of technology to developing countries has been one of the most discussed areas of international economic relations in the past thirty or more years. As a result, many developing countries have implemented policy initiatives and produced a significant number of legal provisions both in national law and in international instruments that seek to regulate it.

However, the impact of FDI on technology generation in developing countries has so far been limited. TNCs tend to centralize their research and development facilities in their home countries as well as a few other industrially advanced countries.

Additionally, recent work, including recent reports by UNCTAD, show why importing and mastering technologies in developing countries is not as easy as earlier assumed. At an earlier stage in the debate on technology transfer to developing countries, it was assumed that the main issue to be resolved was securing access to new technology. What has become increasingly apparent since that time is that the mere possession of technology does not result in improved technical development or economic gain: the capacity to understand, interact with and learn from that technology is critical. Thus, in the contemporary context, the design of policies must rely on an understanding of the technology development process, the role of TNCs in this process, and their interactions with local learning.

In this context the main issues that arise in relation to the generation, transfer and diffusion of technology in a host country are the type of policy measures used by governments to influence technology development.

The draft UNCTAD Code of Conduct on the Transfer of Technology (TOT Code) addressed the issue from various perspectives:

- Legitimization of specific domestic policies to promote the transfer and diffusion of technology;
- Rules governing the contractual conditions of transfer of technology transactions;
- Special measures on differential treatment for developing countries;
- Measures that would strengthen international cooperation.

The approach was to concentrate on the supply side of the market and to remedy constraints on the acquisition of technology by developing countries caused by the domination of the international technology market by TNCs. In particular, it was proposed to liberalize trade in technology and to introduce guidelines on the terms and conditions of transfer of technology to developing countries.

At the international level, and particularly in the context of IIAs, the following policy issues can be discerned:

- Treatment of proprietary knowledge;
- Competition and technology transfer;
- Technology-related host-country measures.

These policy issues should be seen as interrelated as well. For example, it was the acceptance of the proprietary nature of technology, particularly with regard to patentable knowledge, by TNCs and their home governments that was at the heart of the debates on the content of a new regime for the transfer of technology to developing countries under the draft TOT Code.

2.1 Treatment of proprietary knowledge

IPR regimes have been the classical policy instruments to influence the generation, transfer and diffusion of technology. International rule-making in this field has mainly centered on avoiding or lessening the consequences arising from disparities among domestic intellectual property laws as to the formal and substantial requirements of protection through basic principles aimed at:

- Avoiding discrimination towards foreigners with regard to IPR protection;
- Attenuating the territorial character of IPRs which obliges enterprises willing to expand operations to foreign countries to seek protection in each of them on the basis of differing formal and substantive requirements and procedures.

Due to the increasing importance of technological assets as a source of competitive advantage for TNCs, IPR protection has been incorporated into the multilateral trading system. The TRIPS Agreement is perhaps the most prominent example of such incorporation.

2.2 Competition-related questions

The main interface between the generation, transfer and diffusion of technology and competition law relates to the control of restrictive business practices in licensing agreements – one of the major objectives of the draft TOT Code. The abandonment of the draft TOT Code was due to the then continuing disagreement between developing and developed country models of technology transfer regulation. The former wished to take an economic regulation oriented approach which concentrated on the review of clauses in technology licensing agreements with a view to the prohibition of those clauses seen as contrary to the development process or likely to take advantage of the weaker bargaining position of the local technology recipient. The latter saw the issue primarily as one of ensuring effective competition in the transfer of technology and, accordingly, held the view that only those clauses that could be seen as unreasonable restrictions on the freedom of the recipient to compete, or which placed unreasonable restraints on the competitive freedom of third parties, would be regulated. These two policy goals do not necessarily produce the same results. For example, a reasonable tie-in clause might be acceptable on a competition-based analysis, but may be seen as a barrier to the development of local supply chains in the context of a developing country economy (Muchlinski, 1999: 433-436).

Much of this debate has now been overtaken by the orientation of the TRIPS agreement. The new rules that it has introduced, which follow the competition-oriented model of technology transfer regulation, have made many instruments used in the past by the then newly industrializing countries difficult to apply. Specialized technology transfer laws are perhaps the best example here. On the other hand, there is scope for competitiveness-oriented strategies to be adopted by developing countries to improve their ability to assimilate and develop technology.

2.3 Technology-related host-country measures

Once admitted into a country, foreign firms are subject to the host country's jurisdiction. Thus, industrial policies have traditionally been within the regulatory domain of the host country. Governments still retain a space to adopt industrial policies to attract FDI and to increase its benefit to the host economy. However, the legal regulation of FDI is now increasingly accepted as a matter of international concern.

Recent years have seen the emergence of limitations imposed upon host countries by international agreements as to the form in which some domestic policies are applied. In this regard, certain host country operational measures, aimed at inducing foreign investors to adopt a more active approach towards the transfer and dissemination of technology, may no longer be capable of being adopted by countries that have acceded to international instruments containing such limitations.

In terms of subject-matter, the following technology-related host-country measures may have an impact on the pace and direction of technology transfer to and dissemination in a developing host country:

- Restrictions on employment of foreign professional and technical personnel, and requirements concerning the training of local personnel;

- Transfer of technology requirements;
- Restrictions on royalty payments;
- R&D requirements.

Each type of requirement aims to alter the conditions under which investors apply their technological capabilities in a host country context. Thus an investor may be required to limit the number of foreign professional and technical personnel and increase the number of local personnel who can be trained, up to international standards. Equally, a host country may require that specific types of technology, seen as being of importance to the host economy in general and/or to the industry concerned, are transferred to the host country by a foreign investor. Furthermore, the level of royalty that is charged by a foreign investor for the transfer of the technology in question, whether to an affiliate or third-party recipient, may be subjected to scrutiny to ensure that the consideration that is being paid for access to that technology is reasonable.

Finally, a host country may require that a foreign investor establish a level of R&D activity in the host county so as to develop the technology in question in accordance with local needs and/or so as to offer higher value-added activities in the host country associated with the presence of that technology. As noted above, whether such measures can be taken by a host country now depends on the nature and content of that country's international commitments regarding the imposition of performance requirements upon foreign investors.

Exercises and questions for discussion

1. What is the role of TNCs with regard to the transfer of technology?
2. Why is the transfer of technology of importance for developing countries?
3. Cite and explain the different policies in order to promote techonology transfer.
4. What is your opinion concerning mandatory transfer or licensing requirements or other restrictions on the protection of IPRs?

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Theme 6
Investment and corporate governance

INTRODUCTION

Corporate governance has evolved and grown significantly in the last decade. The internationalization of cross-border portfolios and the financial crises that have occurred in various countries have triggered the necessity to improve the integrity, transparency and accountability of corporations. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.

At the end of this theme, students should be able to:

- Understand the interaction between corporate governance and foreign investments;
- Identify main concepts regarding corporate governance; and
- Understand and analyse main features of corporate governance issues.

HANDBOOK

1 Explanation of the issue

1.1 Definition

There are actually many different definitions of corporate governance but they all address the following elements:

- Systems of controls within the company;
- Relationships between the company's board/ shareholders/stakeholders;
- Management of the company in the interests of the shareholders (stakeholders);
- Transparency and accountability to enable users of corporate information to determine whether the business is being managed in a way that they consider appropriate.

Box 125

Definition of corporate governance

"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined". (OECD, 2002)

"(...) The way in which a company organizes and manages itself to ensure that all financial stakeholders receive their fair share of a company's earnings and assets" (Standard & Poor's).

"Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general in general meeting" (Cadbury, 1992).

Generally, corporate governance looks at the institutional and policy framework in corporations – from their very beginnings in entrepreneurship, through their governance structures, company law and privatization, to market exit and insolvency.

1.2 Codes and recommendations

There is no single model of good corporate governance. However, numerous countries and international organizations have issued corporate governance codes and recommendations that typify and identify some common elements that underlie good corporate governance. These codes are non-binding rules that go beyond the law, taking country-specific conditions into account. They do not aim to provide detailed prescriptions for national legislation, rather, they seek to identify objectives and suggest various means for achieving them. Their purpose is to serve as a reference point and soft law.

Codes and recommendations can be used by policy makers as they examine and develop the legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices. While adherence to such codes and standards is voluntary, compliance by specific companies sends a signal to investors to help them identify candidates that match their criteria for investment.

Box 126

Examples of codes

Codes can be divided into supranational, national or institutional codes:

Supranational Codes
Examples of supranational codes include those of the OECD, the International Corporate Governance Network (ICGN), and the Commonwealth Association for Corporate Governance (AGN).

Box 126

Examples of codes

National codes
Examples of national codes include the Viénot Report from France, as well as the Cadbury, Greenbury and Hampel Reports and the Combined Code from the United Kingdom.

Institutional Codes
Examples of institutional codes are those of: Calpers, Hermes Investment Management, and Amnesty International.

Source: Codes of Best Practice for Corporate Governance; Ethos, Swiss Investment Foundation for Sustainable Developments; March 2001.

The OECD Principles of Corporate Governance are a good example of these codes. They were endorsed by OECD Ministers in 1999 and reviewed in 2002. They have since become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. The principles are formulated to embrace the different models that exist. The OECD identifies five key elements of good corporate governance that are followed by a number of supporting subprinciples.

Box 127

OECD key elements of good corporate governance

- The rights of shareholders and key ownership functions;
- The equitable treatment of shareholders;
- The role of stakeholders in corporate governance;
- Disclosure and transparency;
- The responsibilities of the board.

At the national level, there are several good examples. One of the first and most prominent examples is the 1992 report of the United Kingdom Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury, former chairman of Cadbury Schweppes and a director of the Bank of England. The Cadbury Report focused on the control and reporting functions of boards, and on the role of auditors. At the heart of the committee's recommendations is a Code of Best Practice designed to achieve the necessary high standards of corporate behaviour through three main principles that go together: openness, integrity and accountability. The recommendations of the Cadbury's Report influenced the development of corporate governance not just in the United Kingdom, but also in many other countries, including Russia and India.

Box 128

Cadbury's Report

Principles of the code of best practice

Openness. Openness on the part of companies, within the limits set by their competitive position, is the basis for the confidence, which needs to exist between business and all those who have a stake in its success. An open approach to the disclosure of information contributes to the efficient working of the market economy, prompts boards to take effective action and allows shareholders and others to scrutinize companies more thoroughly.

Integrity. Integrity means both straightforward dealing and completeness. What is required of financial reporting is that it should be honest and that it should present a balanced picture of the state of the company's affairs. The integrity of reports depends on the integrity of those who prepare and present them.

Accountability. Boards of directors are accountable to their shareholders and both have to play their part in making that accountability effective. Boards of directors need to do so through the quality of the information, which they provide to shareholders, and shareholders through their willingness to exercise their responsibilities as owners.

Summary of the code of best practices

- Companies should establish key board committees covering audit (composed of non-executive directors, responsible to the board); remuneration (responsible to the board for recommending remuneration of directors; nomination (a formal and transparent procedure for the appointment of new directors to the board).

Box 128

Cadbury's Report

- **There should be at least three independent non-executive directors.**
- **The board should include a balance of executives and non-executive directors, so that no individual can dominate the board's decision making.**
- **There should be separation between the roles of chair (responsible for running the board) and the chief executive officer responsible for running the business).**

2 Good corporate governance and FDI

Corporate governance issues are not a common issue in IIAs, although some recent agreements tend to incorporate non-binding provisions. The most prominent example is the article on corporate stewardship of the Free Trade Agreement between Chile and the US.

Box 129

Example of corporate stewardship: FTA Chile – US

Article 19.10: Principles of Corporate Stewardship
Recognizing the substantial benefits brought by international trade and investment as well as the opportunity for enterprises to implement policies for sustainable development that seek to ensure coherence between social, economic and environmental objectives, each party should encourage enterprises operating within its territory or jurisdiction to voluntarily incorporate sound principles of corporate stewardship in their internal policies, such as those principles or agreements that have been endorsed by both parties.

As mentioned above, the issue on corporate governance is more commonly regulated through non-binding codes or principles that seek to create a general framework that should be adopted in national regulations.

An example of this soft law approach is the APEC Non-Binding Investment Principles that recall, under the heading "investor behaviour" that "acceptance of foreign investment is facilitated when foreign investors abide by the host economy's laws, regulations, administrative guidelines and policies, just as domestic investors should". Other initiatives could be mentioned here, such the Global Compact launched by the UN Secretary-General, Kofi Annan, aiming at the observance by TNCs of basic human rights, labour rights and environment protection.

The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions. In other words, if countries are to reap the full benefits of the global capital market, and if they are to attract long-term capital, corporate governance arrangements must be credible, well understood across borders and adhere to internationally accepted principles. Even if corporations do not rely primarily on foreign sources of capital, adherence to good corporate governance practices will help improve the confidence of domestic investors, reduce the cost of capital, underpin the good functioning of financial markets, and ultimately induce more stable sources of financing. Corporate governance structures of a country are therefore a further important indicator of the credibility of the economy as a whole and of the financial market in particular.

In this context, the relation between corporate governance practices and the increasingly international character of investment is of particular relevance. The OECD, for example, explains the importance of this relation as follows:

> "The disclosure of the corporation's contractual and governance structures may reduce uncertainties for investors and help lower capital costs by decreasing related risk premium. Such transparency may also encourage a common understanding of the 'rules of the game', and provide employees with information that may help reduce labour friction".

Finally, if a country opts for lax accounting and reporting standards or does not have a reputation for strong corporate governance practices, and if investors are not confident with the level of disclosure, capital will flow elsewhere.

Exercises and questions for discussion

1. Explain the concept of good corporate governance.
2. Explain the main elements of the OECD principles of corporate governance.
3. Explain the relation between corporate governance and foreign investments.

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Theme 7
Investment and employment

INTRODUCTION

Given the growing integration of the world economy, employment practices of transnational corporations have increasingly come under international scrutiny. Besides the importance of their employment-generating potential, TNCs – as a major force in the transnationalization of the world's economies – can have a significant impact in a number of key areas related to employment. These include education, training and social benefits. On the other hand, there is concern that TNCs may exploit existing low labour standards in their host countries (sweat shops). At the same time, in their home countries, there is concern about job exports to low salary economies. However, employment and labour issues are relatively uncommon in IIAs. They have only appeared on the agenda of IIAs since the 1970s.

At the end of this theme, students should be able to:

- Understand the interaction between employment and foreign investments;
- Identify main concepts regarding international employment issues; and
- Identify and analyse the different mechanisms implemented in IIAs in order to address employment issues.

HANDBOOK

1 Explanation of the issue

FDI generates employment in host countries directly and indirectly. Foreign affiliates of TNCs directly employ people in their natural resources projects, manufacturing plants and service industries. TNCs also generate indirect employment through enterprises that are suppliers, subcontractors or service providers to them. A key question in this respect is how governments can draw upon the resources offered by TNCs to upgrade their human-capital base while keeping their economy cost-competitive and attractive.

In this context, following ILO and OECD approaches, the following five areas have been identified as being of special importance and particular relevance to FDI and TNC issues.

Employment promotion. The issue of employment promotion is intricately connected with aspirations for economic development. It is particularly important for host developing countries where unemployment is the most serious. The labour force in the developing world is growing each year at around 2 per cent (ILO, 1998; World Bank, 1997). Population growth and increasing labour force participation are continuously adding new entrants to the workforce. Thus, for example, in 1997, open unemployment ranged from 3 to 15% in the urban areas of Latin America and 5 to 20 per cent in the similar areas in Africa; this in addition to a substantial amount of hidden unemployment (UNCTAD, 1999).

Increasing employment thus ranks high as a policy objective for developing countries. While there is no simple method of evaluating the impact of FDI flows on employment creation, in general, positive employment effects have been found to be associated with inward FDI.

Governments therefore pursue, as a major goal, the encouragement of TNCs to stimulate economic growth by promoting the growth of employment.

Opportunity and security of employment. A fundamental right concerning employment issues are that of non-discrimination in employment matters, whether on grounds, *inter alia*, of race, colour, sex, national and social background, religion or political opinion. Equality of opportunity in employment implies that TNCs should base their employment policies on qualifications and skills. A related issue is security of employment. Of particular relevance is the question of how to deal with changes of operations by firms and their effects on employment.

This may, for example, require a set of duties to be observed by firms in the process of restructuring their operations.

Human resources development. A third issue, which flows naturally from the second, concerns the education and training of workers. This issue has become especially significant in recent years as the effects of global economic integration have manifested themselves in changing patterns of employment both in developed and developing countries.

Complex integration strategies of TNCs are likely to involve training programmes with different implications for host and home countries. The issue for many developing countries that host low-skill foreign affiliate manufacturers is how to move themselves towards upgrading skills, higher value-added activities and better quality FDI. The problem is how to change the mix of skills, and ensure that skilled workers find better remunerated employment that is commensurate with such skills while moving up from their established base of competitiveness in low-skill activities.

Conditions of work and life. The main issues of concern here are, first, wages and benefits, and, second, safety and health matters. Considering their size, technological sophistication and origin principally in developed countries, TNCs are often expected to be better employers than domestic firms.

Moreover, foreign affiliates generally have a great deal of autonomy in the determination of wages and working conditions and can therefore go beyond minimum national requirements. On the other hand, TNCs, like all private enterprises, are driven by the profit motive and thus, while generally progressive in terms of pay and conditions of work in host countries, the record of some foreign affiliates raises some concerns. This is especially the case in export processing zones and with respect to the conditions of work and life provided by sub-contractors of TNCs. Also relevant is how to ensure that TNCs maintain high standards of safety and health.

Industrial relations practices. Subject to the legal framework of the host country, decisions affecting the quantity and quality of employment, human resources development and conditions of work and life are primarily the responsibility of management, but these decisions have to be understood in the context of national industrial relations and need to take account of workers' views – hence the importance of trade unions and the right of association. The right of association connotes rights of collective bargaining and consultation, which ensure that workers' representatives have access to employers for the purposes of not only bargaining but of consultation from which information relevant to the bargaining process (that may only be in the possession of employers) is conveyed to those representatives. Furthermore, it is important to ensure that workers' grievances can be aired without prejudice and that appropriate procedures for the settlement of disputes are in place.

2 Employment and IIAs

Since their primary focus is on the promotion and protection of FDI, employment and labour issues are relatively uncommon in IIAs. They have only appeared in the 1970s on the agenda of IIAs, predominantly on the regional or multilateral levels.

The most comprehensive international instruments in this area remain the 1977 ILO Tripartite Declaration and the 1976 OECD Guidelines' Employment Chapter. Most recently, the ILO Declaration of Fundamental Principles and Rights at Work (adopted by the International Labour Conference at its 86th session on 18 June 1998) set out, in paragraph 2, four basic obligations, often referred to as core labour standards.

Box 130

Core labour standards – ILO Declaration 1998

[A]ll members, even if they have not ratified the conventions in question, have an obligation, arising from the very fact of membership in the organisation, to respect, to promote and to realize, in good faith and in accordance with the constitution, the principles concerning the fundamental rights which are the subject of those conventions, namely:

(a) freedom of association and the effective recognition of the right to collective bargaining;
(b) the elimination of all forms of forced or compulsory labour;
(c) the effective abolition of child labour; and
(d) the elimination of discrimination in respect of employment and occupation.

Among these core labour standards, two (freedom of association and non-discrimination) are addressed in the principal international instruments dealing with employment matters. Two others (elimination of forced or compulsory labour and abolition of child labour) however have crystallised in the ILO and OECD but have, until very recently, not been discussed specifically in the context of TNCs. However, to the extent that they are standards of good behaviour for companies in general, they are also relevant to TNCs. This is reflected in the fact that some corporate codes explicitly refer to them.

Box 131

Abolition of child labour – OECD Guidelines 2000

Chapter IV
Enterprises should, within the framework of applicable law, regulations and prevailing labour relations and employment practices:
b) Contribute to the effective abolition of child labour and, in particular, not engage in the worst forms of child labour in their operations;
c) Contribute to the elimination of all forms of forced or compulsory labour and, in particular, not engage in the use of such labour in their operations (...)

A new and rather controversial issue in the FDI/TNC context is one relating to the use of a "social clause" in an IIA. This issue has its origin in the context of trade negotiations. This mechanism has been used to include a social clause in trade agreements to link "workers' rights" – and in particular, certain core labours standards – and trade. Such agreements provide for sanctions in case of non-observance. The clause is characterised by two key elements:

- First, it would be based on already agreed upon and widely ratified international standards contained in ILO conventions.

- Second, it would ensure observance of core labour standards by linking them to market access. The benefits of an agreement would thereby become conditional on the observance of certain workers' rights by contracting parties.

So far, the discussions of a social clause have focused on trade agreements. There are, however, signs that this approach is also beginning to find its way into IIAs. At the bilateral level, for example, the US model BIT mentions labour issues not only in the preamble, but also in a specific provision.

In similar fashion, the draft OECD Multilateral Agreement on Investment text made provision in its preamble for a "no lowering of standards clause".

Box 132

Provision on labour standards: USA BIT model, 2004

Article 13: Investment and Labour

1. The parties recognize that it is inappropriate to encourage investment by weakening or reducing the protections afforded in domestic labour laws. Accordingly, each party shall strive to ensure that it does not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such laws in a manner that weakens or reduces adherence to the internationally recognized labour rights referred to in paragraph 2 as an encouragement for the establishment, acquisition, expansion, or retention of an investment in its territory. If a party considers that the other party has offered such an encouragement, it may request consultations with the other party and the two parties shall consult with a view to avoiding any such encouragement.

2. For purposes of this article, "labour laws" means each Party's statutes or regulations,[57] or provisions thereof, that are directly related to the following internationally recognized labour rights:

(a) the right of association;

(b) the right to organize and bargain collectively;

(c) a prohibition on the use of any form of forced or compulsory labour;

(d) labour protections for children and young people, including a minimum age for the employment of children and the prohibition and elimination of the worst forms of child labour; and

(e) acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health.

[57] "Statutes or regulations" for purposes of this article means an act of the US Congress or regulation promulgated pursuant to an act of the US Congress that is enforceable by action of the federal government.

Box 133

Draft MAI formulations for a no-lowering of standards clause

Alternative 1

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

Alternative 2

A contracting party [shall] [should] not waive or otherwise derogate from, or offer to waive or otherwise derogate from [domestic] health, safety or environmental [measures] [standards] or [domestic] [core] labour standards as an encouragement for the establishment, acquisition, expansion or retention of an investment of an investor.

Alternative 3

1. The parties recognise that it is inappropriate to encourage investment by lowering domestic health, safety or environmental measures or relaxing international core labour standards.

2. A contracting party [shall] [should] accord to investors of another contracting party and their investments treatment no more favourable than it accords its own investors by waiving or otherwise derogating from, or offering to waive or otherwise derogate from domestic health, safety, environmental or labour measures, with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of an investment.

Box 133

Draft MAI formulations for a no-lowering of standards clause

3. A contracting party [shall] [should] not take any measure, which derogates from, or offer to derogate from, international health, safety or environmental laws or international core labour standards as an encouragement for investment on its territory.

This issue is also pertinent to the operations of the Multilateral Investment Guarantee Agency (MIGA). Under its Environmental and Social Review Procedures, paragraph 16 stipulates that MIGA will not provide guarantees for certain types of business activities, including enterprises "involving slave labour or child labour inconsistent with internationally recognised norms".

Exercises and questions for discussion

1. Explain the interaction between employment and foreign investments.
2. Cite and explain the main areas that have been identified as being of particular relevance to FDI issues.
3. Explain the concept of a social clause in IIAs.
4. Evaluate the implications of such a clause in IIAs.
5. Imagine that a foreign investor makes an investment in a country, which does not respect all core labour standards. What could be the possible consequences for the investor?

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THEME 8
Investment and environment

INTRODUCTION

Foreign investment can play a crucial role with regard to environmental protection. On one hand, FDI can significantly contribute to improving the environment by developing and applying state-of-the-art technologies. On the other hand, TNCs are sometimes accused of exploiting low environmental standards in their host countries.

Environmental issues cover a broad scope of activities and are dealt with in a wide spectrum of instruments beyond those specific to FDI. The concept of environmental protection is wide, and includes the quality of air, water and soil; the sustainable use of natural resources; human, animal and plant health; macro- and micro-ecosystems as well as other issues. Environmental regulations cover all firms, domestic and foreign-based.

At the end of this theme, students should be able to:

- Understand the interaction between environmental protection and foreign investments;
- Identify main issues regarding environmental issues; and
- Identify and analyse the different mechanisms implemented in IIAs in order to regulate environmental issues.

HANDBOOK

1 Explanation of the issue

An important component of development is environmental welfare and sustainability. It is now generally accepted that, to be effective, environmental protection – from reversing environmental degradation to increasing environmental welfare through the development and use of environmentally sound technologies and management practices – is a matter that has to be pursued by both public and private actors at all levels.

Efforts with regard to environmental preservation are taken primarily at the national level through regulation that applies mandatory, statute-based, rules of conduct. Increasingly, however, private enterprises and non-governmental organizations are also making efforts to contribute to the preservation of the environment. At the international level, cooperation on the preservation of the environment has included efforts to develop working models of sustainable development that integrate economic, social and environmental concerns.

1.1 Protection of the environment at the national level

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

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

1.2 Protection of the environment at the international level

Efforts at the national level are being reflected in instruments at the international level. At the international level the question of how such instruments have addressed the responsibility of the relevant actors, mainly governments and TNCs, concerning environmental protection has been raised.

1.2.1 Provisions relating to the responsibility of governments

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

During negotiations of the OECD Multilateral Agreement on Investment, certain language to be used in the preamble was proposed by the chairperson of the negotiations as part of the "package" of environmental provisions, as follows:

> "Recognising that investment, as an engine of economic growth, can play a key role in ensuring that economic growth is sustainable, when accompanied by appropriate environmental and labour policies; (...)
>
> Re-affirming their commitment to the Rio Declaration on Environment and Development, and Agenda 21 and the Programme for its Further Implementation, including the principles of the polluter pays and the precautionary approach; and resolving to implement this Agreement in a manner consistent with sustainable development and with environmental protection and conservation".

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

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

> "In order to facilitate the attainment of the industrial development objectives of the ACP States, it is important to ensure that an integrated and sustainable development strategy, which links activities in different sectors to each other, is evolved. Thus sectoral strategies for agricultural and rural development, manufacturing, mining, energy, infrastructure and services should be designed in such a way as to foster inter-linkages within and between economic sectors with a view to maximizing local value added and creating, where possible, an effective capacity to export manufactured products, while ensuring the protection of the environment and natural resources.
>
> In pursuit of these objectives the contracting parties shall have recourse to the provisions on trade promotion for ACP products and private investments, in addition to the specific provisions on industrial cooperation".

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

Lomé IV was replaced in 2000 by the Cotonou Agreement, which introduces a number of clauses that link economic development and the environment. The link, more specifically, between FDI and the environment in the Cotonou Agreement may not be apparent at first glance. It is provided for, however, at the outset, in Article 1 of the Agreement entitled "Objectives of the partnership". Article 1 states that efforts to integrate "the ACP countries into the world economy in terms of... private investment", which, in the context of this agreement, includes FDI, shall apply and integrate, at every level, the "principles of sustainable management of natural resources and the environment". While the number of references with regard to environmental protection has increased significantly in this instrument, they nevertheless comprise statements of objectives, political commitments on cooperation and general references to the environment.

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

Some agreements occasionally go beyond general references and address environmental protection in more detail. The Cotonou Agreement calls for enhanced cooperation. Article 32 entitled "Environment and natural resources", provides for cooperation in relation to the protection of specified areas of the environment. According to the principles that underlie the Agreement, environmental consideration must be taken into account in all joint efforts by the parties, including efforts to channel FDI to ACP countries.

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

> "The parties shall, either individually or jointly, take all appropriate and effective measures to prevent, reduce and control significant adverse transboundary environmental impact from proposed activities".

1.2.2 Provisions relating to the responsibility of TNCs

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

In the 2000 OECD Guidelines, the string reference was replaced by a dedicated paragraph 1, which, again under "General Policies", states that "enterprises should (...) contribute to economic, social and environmental progress with a view to achieving sustainable development".

Paragraph 2 of the Commentary on the 2000 OECD Guidelines, under the heading "Commentary on General Policies", unambiguously states that "obeying domestic law is the first obligation of business". Thus, recommendations seek to promote corporate action and results that go beyond those envisioned under domestic law. This demonstrates how guidelines have evolved on the subject of environmental protection. Guidelines are addressed to TNCs, not to governments. They are non-binding commitments. Nevertheless, it should be noted that the 2000 OECD Guidelines' implementation procedures – an important component of the instrument – were strengthened with comparison to its predecessors.

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

Beyond general references, provisions in agreements sometimes address, with some specificity, the responsibility of TNCs with respect to the environment. The Draft United Nations Code of Conduct on Transnational Corporations does so in some detail.

Box 134

The Draft United Nations Code of Conduct on Transnational Corporations

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

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

Transnational corporations shall/should, in respect of the products, processes and services they have introduced or propose to introduce in any country, supply to the competent authorities of that country on request or on a regular basis, as specified by these authorities, all relevant information concerning:
Characteristics of these products, processes and other activities including experimental uses and related aspects which may harm the environment (...).

NGOs have been particularly active in addressing environmental matters. An example is the Principles of the Coalition for Environmentally Responsible Economies (CERES), a document that was drafted by an investor grouping. The endorsers of the CERES Principles affirm in the introduction their "belief that corporations have a responsibility for the environment, and must conduct all aspects of their business as responsible stewards of the environment by operating in a manner that protects the earth". This includes a pledge to "update (...) practices constantly in light of advances in technology and new understandings in health and environmental science". The document highlights the commitment to reduce or eliminate damage to certain areas of the environment, such as the biosphere and natural resources.

2 Environmental protection in IIAs

With the exception of some developed countries BIT models (e.g. the US and Belgium) BITs are largely silent on the issue of environmental protection. Various, recent IIAs, however, have addressed the issue of environmental protection in two ways. They are including not only provisions that seek to preserve the national regulatory space for environmental protection, but also provisions that prohibit the lowering of environmental standards in order to attract foreign investments.

2.1 Preserving national regulatory space for environmental protection

From a regulatory perspective, the need to accommodate national environmental concerns can sometimes conflict with obligations contained in IIAs. Without the preservation of some flexibility to regulate for the protection of the environment, therefore, a number of measures could be construed as triggering a State's breach of its obligations under IIAs. One way in which the general protection of the environment can be addressed in IIAs is, therefore, to ensure that governments seeking to protect the environment cannot be challenged as acting contrary to their obligations under IIAs (have sufficient national regulatory space for environmental protection).

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

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

Similar language is contained in article G-14(1) of the 1996 Canada-Chile Free Trade Agreement, which actually uses the NAFTA language verbatim.

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

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

> "Each State continues to hold in particular the rights to decide the geographical areas within its Area to be made available for exploration and development of its energy resources, the optimalization of their recovery and the rate at which they may be depleted or otherwise exploited, (...) and to regulate the environmental and safety aspects of such exploration, development and reclamation within its area".

The issue of the right to regulate for environmental protection is of particular importance with regard to the treatment and protection clauses in IIAs. There are concerns that such provisions in IIAs, coupled with investor-State dispute settlement procedures provided for therein, could be used by private investors to challenge measures by host governments intended to preserve the environment. The concern is not merely academic, as is illustrated by a number of cases that have arisen in the context of NAFTA (see in the annex a summary of the Tecmed case).

2.2 Avoiding the attraction of FDI through a lowering of environmental standards

Another means of protecting the environment sometimes included in IIAs is not to relax environmental standards in order to attract FDI. Such a provision has been included in some IIAs in order to answer concerns in both home and host countries that the liberalization of investment rules between States may provide an incentive for host States to lower their environmental standards in order to attract FDI (a so-called "race to the bottom"). It is feared that removing restrictions on flows of capital and products would encourage companies from "high standard countries" to relocate to "low standard countries" (the "pollution haven" hypothesis). Under this hypothesis, investors seek to reduce production costs by relocating, while maintaining access to the markets of both countries.

Box 135

The "pollution haven" hypothesis

There have been several approaches to test the general "pollution haven" hypothesis (Adams, 1997).

The first has been to correlate outward FDI with environmental standards. The results have found no support for the "pollution haven" hypothesis, e.g. the hypothesis that TNCs direct their investment to countries with lax standards (Leonard, 1988; Repetto, 1995; Lucas et al., 1992, Eskeland and Harrison, 1997; Warhurst and Bridge, 1997). One study (Xing and Kolstad, 1997) does find the predicted effect, but its robustness has been questioned because of the use of sulphur dioxide emissions as a proxy for environmental regulation in a larger model of locational choice. Again, the studies find that the environmental variable is rarely significant. The most important variables remain the traditional ones of locational choice: factor endowments, infrastructure quality, distance and market size (Eskeland and Harrison, 1997). There is also a third approach to the use case studies. This approach, which examines specific company decisions, has proved to be more successful in finding cases that support the notion that environmental standards are a factor in TNC location decisions (WWF,

Box 135

The "pollution haven" hypothesis

1998). Examples of both governments failing to enforce environmental legislation and firms acknowledging that lower environmental standards were a factor were found in Costa Rica, Mexico, India, Indonesia, Papua New Guinea and the Philippines (WWF, 1998 and 1999).

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

Some recent US IIAs, (for example the new BIT model) and chapters on investment in FTAs, have included provisions that regulate the relationship between investment and environment.

Box 136

Environment in the USA BIT model, 2004

Article 12: Investment and Environment

1. The Parties recognize that it is inappropriate to encourage investment by weakening or reducing the protections afforded in domestic environmental laws.[58] Accordingly, each Party shall strive to ensure that it does not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such laws in a manner that weakens or reduces the protections afforded in those laws as an encouragement for the establishment, acquisition, expansion, or retention of an investment in its territory. If a Party considers that the other Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.

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

[58] "Laws" for purposes of this article means an act of the US Congress or regulations promulgated pursuant to an act of the US Congress that is enforceable by action of the federal government.

Exercises and questions for discussion

1. Explain the interaction between environmental protection and foreign investment.
2. Explain the different levels of environmental regulation.
3. Identify and analyze regional agreements provisions dealing with environment protection.
4. How is the national regulatory space preserved in IIAs?
5. Explain the mechanisms implemented in IIAs in order to avoid the relaxation of environmental standards.
6. Explain the "pollution haven" hypothesis.

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Annex

ANNEX 1
Compilation of FDI data: Recommendations by the OECD Benchmark Definition of FDI

ANNEX 2
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ANNEX 8
Summaries of selected Dispute Settlement Cases (Module 4)

ANNEX 1

Compilation of FDI data: Recommendations by the OECD Benchmark Definition of FDI[59]

[59] OECD (1996: 12-16).

20. The OECD Benchmark Definition recommends market value as the conceptual basis for valuation. Market valuation places all assets at current prices rather than when purchased or last revalued, and allows comparability of assets of different vintages. It allows for consistency between flows and stocks of assets of different enterprises, industries, and countries, as well as over time.

21. Although the OECD affirms the principle of market value as the basis for valuation, it recognizes that in practice book values from the balance sheets of direct investment enterprises (or investors) generally are utilised to determine the value of the stocks of direct investment. This approach reflects the fact that enterprise balance sheet values – whether they are regularly revalued on a current market value basis, reported on a historical cost basis, or are based on some interim but not current revaluation – represent the only source of valuation of assets and liabilities readily available in most countries. (In the first case, the balance sheet value is, in fact, the market value). The collection of data from enterprises on a current market value basis is to be encouraged, to narrow the gap between principle and practice. If feasible, countries that produce data on market values derived indirectly should also produce data on a book value basis, if the two differ.

1 Stock components

22. The OECD recommends that the stock of direct investment be measured as:

(a) *For subsidiary and associate companies:*

(i) the market value (or where market value is not available for statistical purposes, the book value – derived from the balance sheets – which is likely to be used by a number of countries for practical purposes) of their share capital and reserves attributable to the direct investor. (Reserves include retained profits. Share capital and reserves should be measured as the market value or written-down book value of the company's fixed assets and the market value or book value of its security holdings and other assets, less its liabilities and provisions);
(ii) plus loans, trade credit and debt securities (bonds, notes, money markets instruments, financial derivatives, etc.) due from the subsidiaries and associates to the direct investor, including dividends declared but not yet paid to the direct investor;
(iii) less loans, trade credit and other liabilities (including equity and debt securities) due to subsidiaries and associates from the direct investor.

(b) *For branches, the net worth of these concerns to the direct investor measured as:*

(i) the market value (or, where market value is not available, written-down book value – derived from balance sheets) of the concern's fixed assets, and the market value (or, where market value is not available, the book value) of its investments and current assets, excluding amounts due from the direct investor;
(ii) less the concern's liabilities to third parties.

23. The OECD recommends that short-term loans and trade credit be included as there is often no clear distinction between short-term finance such as a loan repayable on demand but never repaid and long-term finance. Inclusion of inter-company debt and of loans from subsidiaries to parent companies may result in some cases in negative values of direct investment stocks. As a matter of practice, some countries may not include (or may net out) inter-company debt and loans provided by subsidiaries to their parents. However, the OECD recommends that countries provide information on gross amounts outstanding – i.e. claims on direct investor and liabilities to affiliated enterprises – to facilitate international comparability of direct investment stock data.

24. According to the IMF Balance of Payments Manual, Fifth Edition, cross-equity holdings of at least 10 per cent in both directions give rise to two direct investment relationships and should be recorded as direct investment claims and liabilities for both the economy of the direct investment enterprise and the economy of the direct investor.

25. The OECD recommends that the stock of outward investment be converted from foreign currency to the investor's national currency using the closing mid-market spot exchange rate (i.e., average of the closing buying and selling rates) on the day to which the stock figures relate, e.g. if stocks are evaluated at 31st December, the closing mid-market spot rate at 31st December of that same year applies. The OECD does not recommend using the historical exchange rate when the assets and liabilities were acquired.

26. Where subsidiaries, associates and branches resident in one country have assets and liabilities denominated and payable in other currencies, The OECD recommends that these be valued at the closing mid-market spot exchange rate on the day to which the stock figures relate.

2 Capital flows

35. The OECD recommends that direct investment flows be defined as:

(a) *For subsidiary and associated companies:*

(i) the direct investor's share of the company's reinvested earnings;
(ii) plus the direct investor's purchases less sales of the company's shares, debt securities (bonds, notes, money market and financial derivative instruments) and loans (including non-cash acquisitions made against equipment, manufacturing rights, etc.);
(iii) less the company's purchases less sales of the direct investors' shares, debt securities (bonds, notes, money market and financial derivative instruments) and loans;
(iv) plus the increase, net of decreases, in trade and other credit (including debt securities) given by the direct investor to the company – usually measured as the net balance of trade and other credit outstanding at the end of the period owing to the direct investor, less the balance outstanding at the beginning of the period, and less the net increase between the opening and closing balances which is due to revaluations and exchange rate movements.

(b) *For branches*,
the increase in unremitted profits plus the net increase in funds received from the direct investor – measured as the increase in the net worth of the enterprise to the investor less increases (net of decreases) due to revaluations and exchange rate movements.

36. In instances of *reverse investment*, in which the enterprises noted in para. 35 a) and b) have an interest in the direct investor, "that interest is regarded as an offset to capital invested by the direct investor (i.e., as disinvestment)", as indicated by the *IMF Balance of Payments Manual*, Fifth Edition. ["In cases in which the equity participation is at least 10 per cent in both directions, (...) such transactions are recorded as direct investment claims and liabilities in both directions (...)" (para. 371).]

37. The OECD recommends that separate figures be collected and published for transactions in shares and in loans and other indebtedness, and that outward investment should be shown separately from inward investment. It is possible for these items to be recorded gross showing investment separate from disinvestment, or recorded net of disinvestments, or recorded net for each enterprise. Analytical usefulness would be improved if the flows were reported at least partly on a gross basis. The OECD recommends that separate figures should be collected for each enterprise of its net flows of investment, i.e., net of disinvestment, in each country; that the net investment for each enterprise should be split between reinvested earnings, shares, loans plus other indebtedness; and that countries in their published figures should give separate totals for the sum of net investments and for the sum of net disinvestments for each item. For example, if Country X's flows of outward direct investment in the share capital of concerns in country Y consisted of gross purchase of 140, 170, 25 and 10 by investors A, B, C and D respectively and of gross disposals of 40, 20, 75 and 90 by A, B, C and D respectively then A and B would have a net investment of 100 and 150 respectively and C and D a net disinvestment of 50 and 80. Country X in its published statistics should show three figures: overall net investment of 120 split between investors with net investment of 250 (sum of A + B) and investors with net disinvestment of 130 (sum of C + D).

38. Some components of the flows will be in foreign currency. The OECD recommends that these be converted into national currency for:

(a) Outward retained profits at the average mid-market spot exchange rate in the period in which the profits were earned.

(b) Shares and loans

(i) at the closing mid-market spot exchange rate for amounts received and at the closing mid-market spot exchange rate for amounts paid on the day received or paid;
(ii) or if converted immediately prior to purchasing the shares and loans, or sold immediately after receipt, the amount of national currency paid or received.

(c) Net balances of subsidiaries and associates and net worth of branches due to the direct investor, at the closing mid-market spot exchange rate at the date to which the balances relate."

ANNEX 2

Sources and methods for FDI data collection[60]

[60] Based on UNCTAD (2008).

1 Variety of sources for FDI data

Many countries have a variety of sources for FDI data, including those collected by the central bank for balance-of-payments purposes and those collected by the board of investment or a similar institution for monitoring and investment promotion purposes.

Owing to the lack of comprehensive FDI data, especially in some developing economies, it is necessary to draw upon the data provided by institutions responsible for the regulation or promotion of FDI. Allowances must then be made for the regulatory framework within which the data were gathered. For example, not all FDI may have to be registered with the authorities in question; it is possible that reinvested earnings or investments in ventures in which the foreign equity stake is below a certain percentage are excluded.

A typical occurrence is that data provided by those institutions are on approved FDI investments rather than on the investments actually implemented. Sometimes, data on geographical and sectoral distribution of FDI is available only for approved investments. In such cases, data on approved investments provide crucial information, but their limitations must be acknowledged. Normally, approved investments are larger than those actually implemented.

2 Foreign exchange records versus company surveys

Very often it is difficult for a country to comply with the recommended definitions and report on all three components of FDI because it relies exclusively on foreign exchange records of the central bank. Thus it is only able to account for capital that crosses its borders and not reinvested earnings. Another approach taken by some countries involves a requirement by the central bank of additional information from foreign investors.

Data on FDI flows are collected primarily for balance-of-payments purposes. However, the data is usually based on the exchange records of the central bank in the framework of the International Transactions Reporting System (ITRS) and are extremely limited in details. Some countries supplement their exchange records data with company surveys or secondary sources. In most cases, this involves a request for information on components of FDI not properly covered in the recording of foreign exchange transactions, the most important of which is reinvested earnings. This generally entails an annual company survey. In some countries, there is also a periodic census or benchmark survey, which covers all aspects of FDI and may extend to other related variables. In several cases – such as Australia, Canada and the United States – surveys are the main sources of FDI information.

Very often, however, stock data is not available for countries because of their reliance on the exchange records. Stock data may also be obtained from company surveys. If FDI flows were also obtained on the same basis, then cumulative FDI flows would equal FDI stocks because it would include, for example, changes in valuation due to depreciation. However, where FDI flow data is collected from exchange records and FDI stock data is derived from company surveys, cumulative FDI flows do not generally match stocks. Once again, one major source of discrepancies is that reinvested earnings are excluded from FDI flow data.

Another difficulty is that equity capital, as well as changes in intra-company loans between parents and affiliates, and reinvested earnings tend to fluctuate considerably between years and can be substantially revised. Although there may be attempts to revise the FDI flow-data series accordingly, it can be difficult to attribute revisions to particular previous years. For that reason, proper adjustments are normally made only at the time of comprehensive surveys. Surveys also allow for a revaluation of assets, which helps to ensure a more accurate assessment of investment stocks.

ANNEX 3

What do changes in FDI mean?[61]

[61] UNCTAD (2004: 347)..

Trends in FDI often differ greatly from indicators of economic performance such as fixed investment flows or stocks, sales and employment in parent firms and/or their foreign affiliates. Nonetheless, FDI is a commonly used indicator of economic activity in TNCs primarily because it is the most widely available indicator published in a timely fashion. Thus, changes in flows or stocks of FDI are often interpreted to signal changes in real economic activity of TNCs, even when there may be no major changes, or vice versa.

The major reason for differences in trends in FDI and trends in the indicators of economic activity, such as those indicated above, is conceptual. When examining investment trends, the net stock of fixed assets (cumulative fixed investment less depreciation) is used as one of the most common measures of capital. On the other hand, FDI flows are a source, not a use, of corporate finance, which makes them different from fixed investment flows conceptually. FDI flows are the sum of equity, reinvested earnings and loans remitted from the parent firm and related firms abroad to an affiliate in which it controls an ownership share above a certain threshold (i.e. 10 per cent). Using the corporate balance sheet that shows total liabilities (equity + loans) equals total assets, FDI stock can then be related to more common measures of capital such as fixed asset stocks as follows:

FDI stock = FDI equity + FDI reinvested earnings + FDI loans = fixed assets + non-fixed assets – (non-FDI equity + non-FDI loans)

In short, an increase in FDI stock (positive net FDI flows) can be used to finance purchases of fixed assets, non-fixed assets (of which the majority are usually financial assets), or a reduction in non-FDI liabilities (equity and/or loans). Thus, to the extent that FDI is used to purchase non-fixed assets or finance reductions in non-FDI liabilities, trends in FDI stock can easily diverge from trends in the accumulation of fixed capital. Moreover, trends in fixed assets may also differ from trends in other measures of real activity, which makes it very important to use the indicator that best describes the activity of concern in a given case.

For example, in both Japan and the United States, FDI flows have increased much more rapidly than fixed investment flows of foreign-owned affiliates, but the reverse is true in China. In China, fixed investment flows of affiliates have always been smaller than FDI flows, but this has not been the case for several years in Japan and the United States when FDI flows were relatively small. In contrast, FDI stocks have increased much more rapidly than measures of real activity, such as fixed asset stocks, sales and employment in China and the United States, but this has not necessarily been the case in Japan where FDI stock, fixed asset stock and employment have all increased rapidly, but sales have grown much more slowly. Finally, in the United States, the rapid growth of FDI stock has been accompanied by much more rapid growth in total assets than in fixed assets, indicating that large portions of the rapid growth in FDI were used to finance the purchase of non-fixed assets. Thus, even these three examples show a great variety of experience, and underline the importance of choosing the indicator that most closely reflects the activity of concern when analyzing TNC activities.

ANNEX 4

Tables (Module 1)

Table 5

Host country determinants of FDI

Host country determinants	Type of FDI by motives of TNCs	Principal economic determinants in host countries
I. Policy framework for FDI • Economic, political and social stability • Rules regarding entry and operations • Standards of treatment of foreign affiliates • Policies on functioning and structure of markets (especially competition and M&A) International trade and FDI agreements • Privatization policy • Trade policy (tariffs and NTBs) and coherence of FDI and trade policies • Tax policy	**A** **Market-seeking**	• Market size and per capita income • Market growth • Access to regional and global market • Country specific consumer preferences • Structure of markets
	B **Resource-seeking**	• Availability of raw materials and natural resources (e.g. for tourism) • Cost of raw materials • Physical infrastructure (ports, roads, railways, power, telecom) • Availability and cost of skilled labor
II. Economic determinants	**C** **Efficiency-seeking**	• Low-cost unskilled labour or skilled labour • Cost of resources and labour adjusted for productivity • Other input costs, e.g. transport and communication costs to and from and within host economy • Regional integration agreements (inter-country division of labour)
III. Business facilitation • Investment promotion • Investment incentives • Hassle costs or red tape (corruption, administrative efficiency, etc.) • Social amenities (quality of life, bilingual schools etc.) • Good infrastructure and support services e.g. banking, legal accountancy services • Social capital, attitude to work	**D** **Strategic asset-seeking**	• Note that this type of FDI takes place through cross-border M&As for a variety of strategic reasons • Availability of firm-specific assets: technological, innovatory, marketing, brand names, etc. • Buying market power or new markets, spreading risks, lowering transaction costs

Source: Author.

Table 6

Shares of foreign affiliates in the exports of selected host economies, all industries and manufacturing, selected years (percentage)

Economy	Year	All industries	Manufacturing[a]	Economy	Year	All industries	Manufacturing[a]
Developed countries				**Developing economies**			
Austria	1995	54	51	**Argentina[f]**	1995	14	
	2006	22	24		2000	29	
Canada[b]	1994	46c	41c	**Bolivia[f]**	1995	11	
	1995	44c	39c		1999	9	
Czech Republic	1999	34	40	**Brazil[f]**	1995	18	
	2006	46	50		2000	21	
Estonia[b]	1995		26[4]	**Chile[f]**	1995	16	
	2000	60	35[d,e]		2000	28	
Finland	1995	8	11	**China**	1995	28	36
	2001	20	29		2002	47	56
France	1995	20	25	**Colombia[f]**	1995	6	
	2001	16	17		2000	14	
Hungary	1998	61		**Costa Rica**	2000	50	
	2000	61					
Ireland[b]	1995	61	100	**Hong Kong (China)**	1995	5	7
	2004	65	113		1997	4	6
Israel	2002	20	31	**India**	1995	2	3
	2003	19	31		2003	4	5
Japan	1995	5	4	**Malaysia**	1985	26	18
	2006	7	7		1995	45	65
Netherlands[b]	1996	37	39	**Mexico[f]**	1995	15	
					2000	31	
Poland[b]	2000	51	55	**Peru[f]**	1995	25	
					2000	24	
Portugal[b]	1996	20	26	**Republic of Korea**	1999		15[g]
	2002	21	28				
Romania	2007	56	74	**Singapore**	1995		42
					2006		34
Slovenia	1996	20	23	**Taiwan Province of China**	1985	17	18
	2005	33	36		1994	16	17
Sweden[b]	1998	24					
	2003	32	44				
United States	1995	17	13				
	2006	14	14				

Sources: Based on UNCTAD, FDI/TNC database.

Notes:

a Share of exports of foreign affiliates in the manufacturing sector in merchandise exports of host economies.

b Data for exports of foreign affiliates refer to exports of majority-owned foreign affiliates only.

c Data for exports of foreign affiliates from OECD (2002).

d Data on the exports of foreign affiliates from Andrea Eltetö (2000).

e 1998.

f Data for exports of foreign affiliates were provided by ECLAC, International Trade and Integration Division. Based on a sample of 385 foreign-owned firms, 82 in Argentina, 160 in Brazil, 20 in Chile, 21 in Colombia, 93 in Mexico and 9 in Peru.

g Data from Soon (2001), based on exports of 267 exporting companies out of a sample of 305 manufacturing foreign affiliates, accounting for 47.5 per cent of the stock of FDI in the Republic of Korea. Total exports generated by foreign affiliates are thus likely to be considerably larger (based on a survey undertaken by the Korea Institute of Economy and Technology).

Table 7

The world's top 25 non-financial TNCs, ranked by foreign assets, 2005 (millions of US dollars and number of employees)

Ranking by					Assets		Sales		Employment		
Foreign assets	TNI [b]	Corporation	Home economy	Industry [c]	Foreign	Total	Foreign	Total	Foreign	Total	TNI[b] (%)
1	76	General Electric	USA	Electrical & electronic equipment	420 300	759 337	86 519	172 738	168 112	327 000	51.4
2	6	Vodafone Group Plc	UK	Telecommunications	230 600	254 948	60 317	71 070	62 008	72 375	87.0
3	35	Royal Dutch/Shell Group	NL/UK	Petroleum expl./ref./distr.	196 828	269 470	207 317	355 782	86 000	104 000	71.3
4	23	British Petroleum Company Plc	UK	Petroleum expl./ref./distr.	185 323	236 076	223 216	284 365	80 600	97 600	79.9
5	41	Exxon-Mobil	USA	Petroleum expl./ref./distr.	174 726	242 082	269 184	390 328	50 904	80 800	68.0
6	75	Toyota Motor Corporation	JP	Motor vehicles	153 406	284 722	145 815	230 607	121 775	316 121	51.9
7	26	Total	FR	Petroleum expl./ref./distr.	143 814	167 144	177 835	233 699	59 146	96 442	74.5
8	94	Electricité De France	FR	Electricity, gas and water	128 971	274 031	40 343	87 792	16 971	154 033	34.7
9	78	Ford Motor Company	USA	Motor vehicles	127 854	276 459	91 581	172 455	134 734	246 000	51.4
10	69	E.On AG	GER	Electricity, gas and water	123 443	202 111	41 391	101 179	53 344	90 758	53.6
11	3	ArcelorMittal	USA	Metals and metal products	119 491	133 625	105 216	105 216	244 872	311 000	89.4
12	38	Telefónica SA	SP	Telecommunications	107 603	155 856	52 084	83 087	192 127	245 427	70.0
13	59	Volkswagen Group	GER	Motor vehicles	104 382	213 981	120 761	160 308	153 388	328 594	56.9
14	90	ConocoPhillips	USA	Petroleum expl./ref./distr.	103 457	177 757	56 004	187 437	14 591	32 600	44.3
15	33	Siemens AG	GER	Electrical & electronic equipment	103 055	134 778	75 961	106 651	272 000	398 000	72.0
16	63	DaimlerChrysler AG	GER/USA	Motor vehicles	100 458	198 872	113 083	146 326	105 703	272 382	55.5
17	56	Chevron Corporation	USA	Petroleum expl./ref./distr.	97 533	148 786	120 085	214 091	34 000	65 000	58.0
18	74	France Telecom	FR	Telecommunications	97 011	148 952	36 954	77 961	81 159	187 331	52.0
19	85	Deutsche Telekom AG	GER	Telecommunications	96 005	177 630	46 845	92 030	92 488	241 426	47.8
20	39	Suez	FR	Electricity, gas and water	90 735	116 483	52 322	69 888	82 070	149 131	69.3
21	61	BMW AG	GER	Motor vehicles	84 362	131 013	64 920	82 464	27 376	107 539	56.2
22	13	Hutchison Whampoa Limited	HK,CN	Diversified	83 411	102 445	33 260	39 579	190 428	230 000	82.7
23	16	Honda Motor Co Ltd	JP	Motor vehicles	83 232	110 663	87 276	105 288	158 962	178 960	82.3
24	68	Eni Group	IT	Petroleum expl./ref./distr.	78 368	149 360	73 473	128 450	39 319	75 862	53.8
25	29	EADS	NL	Aircrafts and parts	75 126	111 079	52 514	57 593	72 471	116 493	73.7

Source: UNCTAD, Erasmus University database.

Notes:

a All data are based on the companies' annual reports unless otherwise stated.

b TNI, the Transnationlity Index, is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

c Industry classification for companies follows the United States Standard Industrial Classification as used by the United States Securities and Exchange Commission (SEC).

d In the number of cases foreign employment data are calculated by applying the share of foreign employment in total employment of the previous year to total employment of 2007.

Note: The list covers non-financial TNCs only. In some companies, foreign investors may hold a minority share of more than 10 per cent.

Table 8

Possible contributions of inward FDI to various aspects of host economies			
Issue	**Positive contribution**	**Negative contribution**	**Host country characteristics that favour positive contributions**
1. Resources	By providing additional resources and capabilities, viz. capital, technology management skills, access to markets	May provide too few, or wrong kind of resources and assets. Can cut off foreign markets compared with those serviced by domestic firms. Can fail to adjust to localized capabilities and needs.	Availability of local resources at low real cost, particularly those complementary to those provided by foreign firms. Minimal structural distortions or institutional impediments to upgrading of indigenous assets. Development strategies that help promote dynamic comparative advantage.
2. Entrepreneurship	By injecting new entrepreneurship, management styles, work cultures and more dynamic competitive practices.	An inability of foreign entrepreneurship, management styles and working practices to accommodate or, where appropriate, change local business cultures. The introduction of foreign industrial relations procedures may lead to industrial unrest. The pursuance of anti-competitive practices may lead to an unacceptable degree of market concentration.	The policies pursued by host governments to promote local entrepreneurship and a keen and customer-driven work ethic; the character and efficiency of capital markets; the effectiveness of appropriate market-facilitating policies. Large countries may find it easier to introduce some of these conditions than smaller countries.
3. Efficiency	By a more efficient resource allocation, competitive stimulus and spillover effects on suppliers and/or customers. FDI can help upgrade domestic resources and capabilities as well as the productivity of indigenous firms, and foster clusters of related activities to the benefit of the participating firms.	Can limit the upgrading of indigenous resources and capabilities by restricting local production to low value-added activities and importing the major proportion of higher value-added intermediate products. May also reduce the opportunities for domestic agglomerative economies by confining its linkages to foreign suppliers and industrial customers.	The form and efficiency of macro-organizational policies and administrative regimes. In particular, the benefits likely to be derived from FDI rest on host governments providing an adequate legal, commercial and assigning priority to policies that help upgrade human and technological capabilities and encouraging regional clusters of related activities, e.g. science and industrial parks.
4. Tax revenue	By adding to the host nation's gross domestic product, via 1-3 above, and by providing additional tax revenue to governments.	By restricting the growth of GDP via 1-3 above. By transfer pricing or other devices to lower taxes paid to host governments.	See 1-3 above. Suitable policies of tax authorities of host governments to minimize transfer pricing abuse. Countries that have the most to offer TNCs are likely to be the most successful in implementing these policies.
5. Balance of payments	By improving the balance of payments, through import substitution, export generating or efficiency-seeking investments.	By worsening the balance of payments, through limiting exports and promoting imports and out-competing indigenous firms that export more and import less.	Need to take a long view of importing and exporting behaviour of foreign affiliates. The key issue is not the balance of payments *per se*, but the contribution of FDI to economic efficiency, growth and stability. However, countries with a chronic balance-of-payment deficit may find it difficult to completely liberalize their balance-of-payments policies.

Table 8

Possible contributions of inward FDI to various aspects of host economies			
6. International economic integration	By linking better the host economy with the global marketplace and helping to advance economic growth by fostering a more efficient international division of labour.	By worsening the balance of payments, through limiting exports and promoting imports and out-competing indigenous firms that export more and import less.	As 3 above and, in particular, the extent to which host country governments can pursue policies that encourage investing firms to upgrade their value-added activities and invest in activities that enhance the dynamic comparative advantage of indigenous resources. The gains from 6 are particularly important for smaller countries.
7. Political, social and cultural	By more directly exposing the host economy to the political and economic systems of other countries; the values and demand structures of foreign households; attitudes to work practices; incentives; industrial relations and foreign workers; and many different customs and behavioral norms of foreign societies.	By causing political, social and cultural unrest or divisiveness; by the introduction of unacceptable values (e.g. with respect to advertising, business customs, labour practices and environmental standards); and by the direct interference of foreign companies in the political regime or electoral process of the host country.	The extent which a society is strong and stable enough to adjust smoothly to technological and political change. Also, the strength and quality of government regulations and norms; the nature of the host country's goals and its perceived trade-off between, for instance, economic growth, political sovereignty and cultural autonomy. The difficulties in optimizing the benefits of the openness induced by FDI will be greatest in countries which are most culturally distinct from their trading or investing partners.

Source: UNCTAD (1999: 235).

ANNEX 5

Investment promotion[62]

[62] Investment promotion does not normally come under the scope of IIAs. This annex is intended only as background reading if needed, and can be used at the discretion of teachers and/or students.

1 Investor targeting by region and industry

Instead of trying to promote investment from all parts of the world and of all kinds, IPAs are applying different ways of narrowing the scope for their promotional efforts. Thus, investor targeting can mean focusing on a certain region and industry.

Some IPAs have gone a step further and established special programmes for attracting investment in specific industries, such as in Ireland (box 137). Such programmes most frequently are designed for the attraction of high-tech investment, but they may target, for instance, environment-friendly technology projects as well.

Box 137

Ireland: Attracting Foreign Investment for call centres

In pursuing its long-term strategy, the Industrial Development Agency (IDA) of Ireland focuses on specific sectors and activities for investment promotion. The selected ones must: (a) show a high potential for attracting international mobile investment and (b) require an operating environment that is readily available in Ireland. One such industry is call centres. IDA determined that the main costs involved in operating call centres were derived from telecommunications and labour. Ireland views these as areas of comparative advantages that can be exploited to promote inward FDI.

IDA received strong government support in its quest to develop a suitable enabling environment. Up to US$5 billion was invested in Ireland's telecommunication infrastructure over a period of 15 years to make it among the most advanced in Europe. Sophisticated technology provides customized solutions for call centre problems. International toll-free services were made available to and from every major business centre in Europe, the United States and many other countries. In addition, an attractive fiscal regime was put in place, providing the location with an additional competitive edge.

Against this background, IDA actively began to promote internationally the advantages that Ireland could offer operators of call centres: in particular, a modern telecommunication system and a multilingual and flexible labour force. Over 60 companies have chosen Ireland as the base for their European call centres. These global operators employ 6,000 people in Ireland and carry out many of their key business functions there, ranging from handling customer queries, taking orders and providing technical support, to actively pursuing business on a pan-European level.

Source: UNCTAD (2001).

2 Investor targeting by type of investment

Most IPAs have special programmes to target specific investors. Many focus on investors that are already present in the host country. In the total investment promotion effort, importance can be placed on SMEs as well as on large TNCs. Some agencies also target portfolio investors.

The strategies of IPAs differ, furthermore, depending on how desirable certain modes of entry are perceived to be. Some IPAs may seek to stimulate the development of new facilities, thus preferring greenfield investment to M&As.

Another element in investor targeting relates to the size of sought investments that IPAs focus their efforts on. Whereas most of the agencies do not use any minimum size of investments required, some IPAs may target only investments above a certain threshold.

After having targeted and attracted foreign investors, IPAs may also focus on the facilitation of linkages between TNCs and local firms, as part of their strategy for maximizing FDI benefits, such as in Thailand (see box 138).

Box 138

Thailand: Linking investment promotion with the development of SMEs

In recent years increased emphasis has been placed on incorporating the development of national companies, especially small and medium sized enterprises, in investment promotion strategies. Countries benefit more from FDI and the entry of foreign investors if strong linkages exist within the local business environment. Business linkages give impetus to the local economy, support growth, increase employment and upgrade the pool of technical skills and know-how. Thailand's Board of Investment (BOI) has established a Unit for Industrial Linkage Development (BUILD). The primary purpose of this programme is to promote industrial links between foreign investors and local companies in Thailand. These linkages can consist of various kinds of cooperation, from subcontracting and supplier arrangements to licensing and joint-ventures.

The objectives are:
- To encourage the development of supporting industries in Thailand
- To strengthen linkages between principal companies and supplier companies
- To assist small and medium supplier companies to improve efficiency, productivity, and quality
- To foster cooperation between foreign investors, Thai supplier manufacturers and related government agencies
- To remove impediments to subcontracting and improve backward linkage development
- To promote Thailand as a regional base for parts and components production and outsourcing

The BUILD also contains a matchmaking service with a database, which provides information on subcontracting opportunities in Thailand, both by sector and by region. Through using the BUILD mechanism, a suitable partner can be found for foreign firms seeking specific components or raw materials in Thailand. Furthermore, BUILD helps small and medium-sized Thai suppliers achieve the standards required to enter into subcontracting arrangements. For example, BUILD contributes technical and management assistance and coordination of training courses in order to upgrade marketing and technological capabilities of local suppliers and subcontractors.

Source: UNCTAD (2001).

3 Services provided to investors

IPAs differ in the kinds of services they offer to potential and existing investors. The range of services can be divided into pre and post investment decision services.

Pre-investment decision services that are most commonly offered by IPAs are matchmaking services and the provision of domestic market information. IPAs also offer advice on local employment conditions and help to find suitable sites and infrastructure.

IPAs of different country categories carry out relatively similar pre-investment services. In developing countries, they may focus on providing domestic market information, and consider business matchmaking and advice on local employment conditions to be particularly important. Meanwhile, IPAs in OECD countries usually place greater emphasis on investor services related to site selection.

In the knowledge-based information economy, access to adequate infrastructure in terms of information technology can be a critical factor determining the ability of IPAs to provide professional services to investors. Many IPAs offer an electronic database on local contacts for various services, including names and addresses of existing foreign investors. Database support can enable agencies to generate information on domestic business conditions and prices, and on available joint-venture partners.

When other specialized agencies or ministries are also involved in the investment facilitation process (box 139), IPAs are able to act as a guide and coordinator to ensure that the investor finds the right national institutions or government departments.

Box 139

Rajasthan: Operating a single window system

In India, the existence of multiple points of contact for investors and exisiting delays has prompted experiments in creating single window systems. At the central level of the Government of India, the Foreign Investment Promotion Board was established in the early 1990s to provide speedy clearances to all foreign investment proposals. At the State level, similar agencies were established with the same purpose. However, after several years of operation, it is now evident that at both the central and State levels, clearances by the respective investment authorities do not preclude the need to apply to other departments or agencies for numerous approvals and concessions. The substantive departments and agencies form independent opinions on the basis of their departmental understanding of the issues and often make decisions that are at variance with the investment authority.

After conducting a review of the different departments and agencies, the Government of Rajasthan instituted Empowered Committees, which are authorized to take interdepartmental decisions that are final and binding on all departments, and are exempt from further examination. Time limits have been prescribed and no applications can remain pending for decision after the expiry of the prescribed period. Bureau of Investment Promotion (BIP) Rajasthan acts as the Secretariat for two empowered committees handling different magnitudes of investment, i.e. the Board of Infrastructure Development and Investment, chaired by the Chief Minister and the Empowered Committee on Investment, chaired by the Chief Secretary.

Similarly, to reduce delays and avoid investor harassment, a Single Composite Application has been designed which is also compatible with the requirements of Electronic Data Interchange (EDI). The Single Composite Application is to be submitted to BIP. BIP is expected to seek approval from different departments and after consolidating these, issue a single approval letter.

To date, the investor response to these measures has been encouraging and has contributed to enterprises' positive perception of Rajasthan's investment climate.

Source: UNCTAD (2001).

IPAs also provide post-investment-decision services to investors. The most frequent form of post-investment decision support is assistance with registration and licensing, as well as legal advice. As already mentioned, after the foreign companies are established and operational, investment promotion can be extended to aftercare or corporate development support, with various forms of assistance provided by IPAs in order to build mutually profitable, long-term partnerships with TNC management teams. CDS to existing TNCs in host countries is becoming increasingly important as a means both of winning new investment projects for such TNCs, and of raising their performance in line with specific improvements required in the national economy.

4 Promotional Tools

After having determined what countries, sectors and types of investment to target, IPAs can use many different tools to communicate investment opportunities to prospective investors. The methods vary between agencies.

Some IPAs may place a great emphasis on the importance of personal contact for investment promotion. Such personal contacts can be achieved in various ways, including through international conferences and trade fairs, by hosting visiting missions for foreign investors, by organizing meetings and seminars, as well as conducting investment missions to other countries. All these marketing techniques are carried out by most of the agencies.

Although less common than the above mentioned methods, a number of non-personal promotion techniques are relatively popular too. Direct mailing and advertising in foreign media can also be employed. General promotional brochures and investment guides are the most frequently used marketing materials and are also considered to be relatively effective. A great majority of IPAs also recognize the usefulness of websites in their promotional efforts. The number of IPA websites is increasing rapidly (see box 140).

Box 140

Best practices in internet-based investment promotion

The advent of the internet has transformed the concept of distance and has made a wealth of business and investment data available at the click of a mouse. As a result, many organizations are reengineering the manner through which they conduct business at many levels, particularly in the area of marketing their services, and the use of information in their operations. The increased use of the internet has particular implications for IPAs.

For developing countries facing increased competition for foreign investment flows, this new medium opens opportunities to reach potential investors and to close the "information gap" encountered. Today, it is standard practice for an IPA to operate a website providing online access to key investment information on their country or region, such as: an overview analysis of the business environment; recent inward investment trends; key economic data (e.g. GDP per capita, inflation); investment regulatory regime and investor incentives; details of relevant commercial laws and regulations; analysis of high potential sectors and associated factor costs; descriptions of specific investment opportunities; and details of the services the agency provides to potential investors.

Establishing a web presence constitutes a learning experience for an IPA. First generation IPA websites are characterized by a rather passive use of internet facilities and options. More advanced IPAs have gone a step further to demonstrate more proactive uses of the internet, both in terms of marketing outreach as well as research on potential investors. Many websites now provide more in-depth information and analysis, such as detailed comparisons of factor costs (e.g. labour, utilities) with their immediate competitors. These IPAs also update and add new content to their sites on a more frequent basis (e.g. weekly) in order to encourage visitors to return to the site.

Source: UNCTAD (2001).

Naturally, the ability for undertaking certain promotional efforts is significantly affected by the resources available to IPAs. For example, advertising in foreign media for an LDC IPA is considerably more expensive than doing it locally. The size of an IPA's advertising and promotional budget ranges from a few thousand dollars to several million dollars.

The largest item of expenditure within IPA budgets is usually conducting investment missions to other countries, followed by advertising in foreign business media. Websites, which are considered to be very effective promotional tools, appear to be a cost-effective way of marketing investment opportunities.

5 Performance Evaluation

A key challenge for any IPA is to find an appropriate system for the evaluation of its own performance. Investment decisions by firms are affected by a large number of factors and IPAs can therefore never fully claim the full credit from winning an investment project, even if they have played a significant role in the process. Moreover, it may be difficult to develop methods for assessing public sector, non-profit activities such as investment promotion.

These difficulties are well known among IPAs. In fact, most IPAs, according to UNCTAD's survey, state that they do not have any clear performance indicators, neither quantitative nor qualitative, for evaluating their achievements.

On average, not many of the IPAs use quantitative targets with respect to FDI inflows. Common quantitative indicators are the number of investment projects, equity generated and jobs created per year through projects facilitated by the agency.

An even smaller number use qualitative targets. Such targets can refer to specific types of investment defined in a country's investment policy, such as high-tech investment.

One potentially useful indicator for the efficiency of activities and services provided by IPAs is the time for IPAs to respond to individual requests. Timeframes vary considerably between agencies. For example, time limits for providing assistance in acquiring work permits or in advising on local employment conditions vary from one day to one month. The processing of complaints from investors usually requires more time.

6 Best Practice Guidelines for Investment Promotion

To ensure the success of their investment promotion policies, governments and IPAs can also choose to elaborate or adopt guidelines of best practices in this field.

For example, building on OECD member country experience, as well as of many developing and transition economies, the OECD and the SEE Regional Roundtable for Investment Promotion have developed the "Best Practice Guidelines for Investment Promotion". The guidelines show what government commitment is needed and the scope of activity that is encompassed in the approaches of successful FDI policy and promotion in various countries.

While these guidelines focus on smaller countries in transition, the underlying principles also hold true in larger countries, although the motivations and negotiating positions of the investor and the host countries may be different.

The twelve specific guidelines provide an overall "best practice" framework for investment promotion.

Box 141

OECD-SEE Best Practice Guidelines for Investment Promotion

1. **Establish government policy on foreign direct investment and the vision for its role and contribution to the national economic development framework.**

2. **Articulate and advocate national policy on FDI among social partners and civil society as well as investors in order to create a better awareness and consensus on the aims of policy.**

3. **Establish an Investment Promotion Agency (IPA) and determine the objectives and the legislative and governance structures of the agency.**

4. **Inculcate within the IPA a professional management and service culture, result-oriented ethos and innovative marketing approach in order to compete successfully in attracting new investment and to ensure satisfactory continuity of the organization culture.**

5. **Define strategic policy options and set out the corporate strategy and marketing plan for the IPA to build competitive strength and achieve selected policy options.**

6. **Decide on incentives policy and ensure objective and regular evaluation of the costs and benefits.**

7. **Undertake a comprehensive review of skills available versus skills required by investors. Develop and implement policies to address identified gaps and thereby facilitate new investment, jobs and skills.**

8. **Ensure the provision of essential infrastructure needed by industry – industrial estates, modern factory and office buildings, utilities (electricity, gas, water), effluent treatment, drainage, telecommunications (including access to broadband networks) and different modes of transport.**

9. **Identify administrative barriers to FDI and establish a programme with clearly assigned responsibilities and target dates to remove such obstacles to investment.**

10. **Promote FDI by undertaking a comprehensive and professional marketing programme aimed at new and existing investors and by building the IPA as a credible and competent partner for investors.**

11. **Facilitate investment and service new and existing investors at all stages of the investment cycle, from start-up through to post-investment and new expansion stages.**

12. **Encourage greater integration of foreign business into the economy and the rooting of foreign investment in the country.**

Source: OECD (2002).

Box 142

Measures relating to admission and establishment

- Closing certain sectors, industries or activities to FDI.
- Quantitative restrictions on the number of foreign companies admitted in specific sectors, industries or activities.
- Minimum capital requirements.
- Subsequent additional investment or reinvestment requirements.
- Screening, authorization and registration of investment.
- Conditional entry upon investment meeting certain development or other criteria (e.g. environmental responsibility).
- Investment must take certain legal form (e.g. incorporated in accordance with local company law requirements).
- Restrictions on forms of entry (e.g. mergers and adquisitions may not be allowed, or must meet certain additional requirements).
- Special requirements for non-equity forms of investment (e.g., build-operate-transfer (BOT) agreements, licensing of foreign technology).
- Investment not allowed in certain zones or regions within a country.
- Restrictions on import of capital goods needed to set up an investment (e.g. machinery, software).
- Investors required to deposit certain guarantees (e.g. for financial institutions).
- Admission to privatization bids restricted or conditional on additional guarantees, for foreign investors.
- Admission fees (taxes) and incorporation fees (taxes).
- Investors required to comply with norms related to national security, policy, customs, public morals requirements as conditions to entry.

Source: UNCTAD (1996: 176).

Box 143

Measures relating to ownership and control

- Restrictions on foreign ownership (e.g., no more than 50 per cent of foreign owned capital allowed).
- Compulsory joint ventures, either with State participation or with local private investors.
- Mandatory transfers of ownership to local firms, usually over a period of time (fade-out requirements).
- Nationality restrictions on the ownership of the company or shares thereof.
- Restrictions on the use of long-term (5 years or more) foreign loans (e.g. bonds).
- Restrictions on the type of shares or bonds held by foreign investors (e.g. shares with non-voting rights).
- Restrictions on the free transfer of shares or other proprietory rights over the company held by foreign investors (e.g., shares cannot be transferred without permission).
- Restrictions on foreign shareholders rights (e.g. on payment of dividends, reimbursement of capital upon liquidation; on voting rights; denial of information disclosure on certain aspects of the running of the investment).
- "Golden" shares to be held by the host government allowing it, e.g. to intervene if the foreign investor captures more than a certain percentage of the investment.
- Government reserves the right to appoint one or more members of the board of directors.
- Restrictions on the nationality of directors, or limitations on the number of expatriates in top managerial positions.
- Government reserves the right to veto certain decisions, or requires that important board decisions be unanimous.
- Government must be consulted before adopting certain decisions.
- Management restrictions on foreign-controlled monopolies or upon privatization of public companies.
- Restrictions on land or immovable property ownership and transfers thereof.
- Restrictions on industrial or intellectual property ownership or insuficient ownership protection.
- Restrictions on the licensing of foreign technology.

Source: UNCTAD (1996: 177).

Box 144

Measures relating to operations

- Restrictions on employment of foreign key professional or technical personnel, including restrictions associated with granting of visas, permits, etc.
- Performance requirements, such as sourcing/local content requirements, manufacturing requirements; technology transfer requirements, employment requirements, regional and/or global product mandates, training requirements, export requirements, trade-balancing requirements, import restrictions, local sales requirements, linking export quotas to domestic sales, export/foreign exchange earning requirements.
- Public procurement restrictions (e.g. foreign investors excluded as government suppliers or subject to providing special guarantees).
- Restrictions on imports of capital goods, spare parts, manufacturing imputs.
- Restrictions/conditions on access to local raw materials, spare parts and inputs.
- Restrictions on long-term leases of land and real property.
- Restrictions to relocate operations within the country.
- Restrictions to diversify operations.
- Restrictions on access to telecommunications networks.
- Restrictions on the free flow of data.
- Operation restrictions relating to monopolies or participation in public companies (e.g., obligation to provide a public service at a certain price).
- Restrictions on access to local credit facilities.
- Restrictions on access to foreign exchange (e.g., to pay for foreign finance, imports of goods and services or remitting profits).
- Restrictions on repatriation of capital and profits (case by case approval, additional taxation or remittances, phase out of transfers over a number of years).
- "Cultural" restrictions, mainly in relation to educational or media services.
- Disclosure of information requirements (e.g., on the foreign operations of a TNC).
- Special operational requirements on foreign firms in certain sectors/activities (e.g. on branches of foreign banks).
- Operational permits and licences (e.g. to transfer funds).
- Special requirements on professional qualifications, technical standards.
- Advertising restrictions for foreign firms.
- Ceilings on royalties and technical assistance fees or special taxes.
- Limits on the use of certain technologies (e.g. territorial restrictions), brand names, etc., or case-by-case approval and conditions.
- Rules of origin, tracing requirements.
- Linking local production to access or establishment of distribution facilities.
- Operational restrictions related to national security, public order, public morals, etc.

Source: UNCTAD (1996: 179)

Box 145

Main types of incentive measures offered to foreign investors

1. Fiscal incentives, including:

- Reduction of the standard corporate income-tax rate.
- Tax holidays.
- Allowing losses incurred during the holiday period to be written off against future profits.
- Accelerated depreciation allowances on capital taxes.
- Investment and reinvestment allowances.
- Reductions in social security contributions.
- Deductions from taxable earnings based on the number of employees or on other labour-related expenditures.
- Corporate income-tax deductions based on, for example, expenditures relating to marketing and promotional activities.
- Value-added based incentives, including:
- Corporate income-tax reductions or credits based on the net local content of outputs.
- Granting of income-tax credits based on net value earned.
- Import-based incentives, including:

Box 145

Main types of incentive measures offered to foreign investors

- Exemption from import duties on capital goods, equipment or raw materials, parts and inputs related to the production process.
- Tax credits for duties paid on imported materials or supplies.
- Export-based incentives, including:
- Exemptions from export duties.
- Preferential tax treatment of income from exports.
- Income-tax reduction for special foreign-exchange-earning activities or for manufactured exports.
- Tax credits on domestic sales in return for export performance.
- Duty drawbacks.
- Income-tax credits on net local content of exports.
- Deduction of overseas expenditures and capital allowance for export industries.

2. Financial incentives, including:

- "Direct subsidies" to cover (part of) capital, production or marketing costs in relation to an investment project.
- Subsidized loans.
- Loan guarantees.
- Guaranteed export credits.
- Publicly funded venture capital participating in investments involving high commercial risks.
- Government insurance at preferential rates, usually available to cover certain types of risks such as exchange-rate volatility, currency devaluation, or non-commercial risks such as expropriation and political turmoil (often provided through an international agency).

3. Other incentives, including:

- Subsidized dedicated infrastructure.
- Subsidized services, including assistance in identifying sources of finance, implementing and managing projects, carrying out pre-investment studies, information on markets, availability of raw materials and supply of infrastructure, advice on production processes and marketing techniques, assistance with training and retraining, technical facilities for developing know-how or improving quality control.
- Preferential government contracts.
- Closing the market to further entry or the granting of monopoly rights.
- Protection from import competition.
- Special treatment with respect to foreign exchange, including special exchange rates, special foreign debt-to-equity conversion rates, elimination of exchange risks on foreign loans, concessions of foreign exchange credits for export earnings, and special concessions on the repatriation of earnings and capital.

Source: UNCTAD (1996: 180).

ANNEX 6

Examples of Economic Investment Agreements[63]

63 Based on UNCTAD (2006).

1 North-American agreements

North-American Free Trade Agreement

In January 1994, Canada, the US and Mexico launched the NAFTA and formed a free trade area where trade and investment barriers among these three countries were to be eliminated.

NAFTA was an expansion of the earlier Canada-US Free Trade Agreement of 1989. Unlike the European Union, NAFTA does not create a set of supranational governmental bodies, nor does it create a body of law which is superior to national law.

With regard to investment, NAFTA's Chapter 11 contains complex provisions that define the conditions of establishment, treatment and protection of foreign investment, as well as lists of exceptions and reservations of each country to certain commitments, including future non-conforming measures.

Free Trade Area of the Americas (FTAA)

The effort to unite the economies of the American continent into a single free trade agreement began at the Summit of the Americas, held in December 1994 in Miami, US Heads of State and governments of the 34 democracies in the region agreed to negotiate the FTAA, in which barriers to trade and investment will be progressively eliminated.

Nine FTAA Negotiating Groups were created in the following areas: market access; investment; services; government procurement; dispute settlement; agriculture; intellectual property rights; subsidies, antidumping and countervailing duties; and competition policy. These negotiating groups have specific mandates to negotiate text in their subject areas and meet regularly.

The Negotiating Group on Investment is mandated to develop a comprehensive framework that incorporates the rights and obligations on investment.

2 Asian agreements

Asia-Pacific Economic Cooperation

Established in 1989, APEC, with its 21 member economies, is the first forum for facilitating economic growth, cooperation, trade and investment in the Asia-Pacific region.

Known as APEC's "Three Pillars", APEC focuses on: trade and investment liberalization; business facilitation; economic and technical cooperation.

APEC operates on the basis of non-binding commitments and open dialogue. Norms of a non-binding nature relating to foreign investment have been adopted in the 1994 APEC Non-Binding Investment Principles.

Association of South-East Asian Nations

ASEAN was established in 1967 in Bangkok by five original member countries, namely, Indonesia, Malaysia, Philippines, Singapore, and Thailand. Brunei Darussalam joined in 1984, Vietnam in 1995, Laos and Myanmar in 1997, and Cambodia in 1999.

Today, ASEAN economic cooperation covers the following areas: agriculture and forestry, economics (trade), energy, environment, finance, health, information, investment, labour, law, regional haze, rural development and poverty alleviation, science and technology, social welfare, telecommunications, transnational crime, transportation, tourism, youth.

The ASEAN instruments related to investment are:

- ASEAN Agreement of 1987 (Agreement among the Governments of Brunei Darussalam, the Republic of Indonesia, Malaysia, the Republic of the Philippines, the Republic of Singapore and the Kingdom of Thailand for the Promotion and Protection of Investments) amended in 1996;
- Framework Agreement on the ASEAN Investment Area (1998, amended by a Protocol in 2001);
- ASEAN Framework Agreement on Services (1995);
- Short-Term Measures to Enhance ASEAN Investment Climate (1999).

[64] Venezuela announced its withdrawal in 2006, reducing the Andean Community to four member States.

3 Latin America and Caribbean agreements

Andean Community (CAN)

The Andean Community[64] is a subregional organization endowed with an international legal status, which is made up of Bolivia, Colombia, Ecuador, Peru, and the bodies and institutions comprising the Andean Integration System. The Community provisions concerning investment are Decisions 291 and 292. The former contains the general regime governing foreign investment and the latter regulates the case of the Andean multinational enterprises.

National laws and regulations, together with bilateral arrangements or agreements to promote and protect investments, signed by member countries with third countries and even among themselves, complement these provisions.

The Andean Community is a customs union because the goods of its member countries circulate unimpeded throughout its territory free of duties of any sort, while imports from outside the subregion pay a common tariff. The member countries have taken important steps in their commitment to establish a common market. Since meetings held in 2005 the Andean Community has adopted various measures these included greater harmonization of the customs duty and a common foreign policy.

Common Market of the South

Argentina, Brazil, Paraguay and Uruguay signed, in March 1991, the Treaty of Asuncion, creating the Common Market of the South.

In the framework of MERCOSUR, there are two relevant instruments related to investment:

- The 1994 Protocol on the Promotion and Protection of Investments coming from Non-Members (Protocol of Buenos Aires)
- The 1994 Protocol of Colonia for the Reciprocal Promotion of Investments inside MERCOSUR

Although both Protocols encompass the same type of provisions (definitions, treatment and protection of investment and dispute settlement), they differ substantially in the sense of a higher degree of liberalization towards members compared with non-members.

Caribbean Community

The Caribbean Community and Common Market was established by the Treaty of Chaguaramas, which was signed by Barbados, Jamaica, Guyana and Trinidad & Tobago, coming into effect in 1973. Subsequently, other Caribbean territories joint CARICOM: Antigua and Barbuda, Bahamas, Belize, Dominica, Grenada, Haiti, Montserrat, St. Kitts and Nevis, Santa Lucia, St. Vincent and the Grenadines, and Suriname.

Between 1993 and 2000, the Inter-Governmental Task Force which was composed of representatives of all member States, produced nine protocols, for the purpose of amending the Treaty with a goal of creating and enforcing a single market economy. These nine protocols were later combined to create a new version of the treaty, called formally, the Revised Treaty of Chaguaramas Establishing the Caribbean Community, Including the CARICOM Single Market and Economy.

Protocol II, on the **Rights of Establishment, Provision of Services and Movement of Capital** includes relevant provisions on investment, such as national treatment, compensation for losses, and transfers.

4 African and West Asian agreements

African economic cooperation includes the establishment of economic communities such as: ECOWAS (1975), COMESA (1994), the Southern African Development Community (1980), the Economic Community of the Great Lakes Countries (1976), the West African Economic and Monetary Union (1994), the Economic and Monetary Community of Central Africa, CEMAC (1994). Some of them have developed or are developing investment instruments, such as the Common Convention on Investments of the Customs and Economic Union of Central Africa, UDEAC (precursor of CEMAC) in 1965. In a move towards strengthening the integration process of member countries of the COMESA, the COMESA Common Investment Area was signed, with the objective of establishing a free investment area by 1 January 2010.

In West Asia, an agreement within the Council of Arab Economic Unity established the Arab Common Market. Relevant investment related provisions can be found in the Agreement on Investment and Free Movement of Arab Capital among Arab Countries (1970). In addition, the Convention Establishing the Inter-Arab Investment Guarantee Corporation, entered into force in 1974, with membership of all Arab countries (except the Comoros Islands). To achieve the aim of promoting inter-Arab investments and trade, the corporation has developed a guarantee scheme offered to Arab investors.

5 European agreements

European Union

The EU member States have set up common institutions to which they delegate some of their sovereignty so that decisions on specific matters of joint interest can be made at European level. This pooling of sovereignty is also called "European integration". Initially, the EU consisted of just six countries, then it was enlarged to 15; in 2004 the biggest enlargement took place with the addition of 10 new countries.

The EU single market is based on the free movement of goods, persons, services and capital. As of 1 December 2009, with the entry into force of the Lisbon Treaty, there was a shift in competencies between the EU and its member States with regard to FDI. However, many questions remain about the actual and potential implications of this competence shift in rulemaking, including for developing countries negotiating with the EU or its member States as the full extent of the shift in competence is not yet clear.

Organisation for Economic Co-operation and Development

The OECD began as a group of 20 developed countries in 1960, but since then has expanded to include former transition economies and some developing countries. The OECD has a significant history in efforts to develop international rules relating to capital movements, international investment and trade in services. In this respect, OECD produces internationally agreed instruments, decisions and recommendations to promote rules of the game in areas where multilateral agreement is necessary for individual countries to make progress in a globalised economy. These instruments are regularly reviewed and updated.

- **Codes of Liberalisation:** The Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations constitute legally binding instruments. They aim at reducing obstacles to the current payments and maintain and extend the liberalisation of capital movements. Taken together, these two codes serve to liberalize a broad range of transfers relating to investments. Implementation of the codes, in particular by removal of restrictions on cross-border capital flows and trade in services and the concomitant lifting of country reservations against the codes, involves "peer pressure" exercised through policy reviews and country examinations to encourage unilateral rather than negotiated liberalisation. The latest update of the codes dates from September 2004.

- **Declaration and Decisions on International Investment and Multinational Enterprises:** The 1976 Declaration on International Investment and Multinational Enterprises constitutes a policy commitment to improve the investment climate, encourage the positive contribution that multinational enterprises can make to economic and social progress, and minimize and resolve difficulties that may arise from their operations. All 30 OECD member countries, as well as nine non-member countries have subscribed to the declaration. The declaration consists of four elements, each one of these elements being underpinned by a decision by the OECD Council concerning the follow-up procedures: the Guidelines for Multinational Enterprises; National Treatment; Conflicting Requirements; International Investment Incentives and Disincentives. All parts of the declaration are subject to periodical reviews. A major review of the Guidelines for Multinational Enterprises was completed in June 2000.

- **Draft Multilateral Agreement on Investment:** although it has not met the consensus of the member countries, the draft MAI remains a useful reference for analysing and drafting various types of investment provisions.

6 Interregional agreements

Besides many agreements between a REIO (namely the EU) and third countries, there are also significant agreements negotiated between two blocs of countries.

Perhaps the most important trade agreement outside the WTO agreements is the African, Caribbean and Pacific and the European Union relation under the Cotonou Agreement signed in June 2000, as a successor to the Lomé Convention, which had guided these relations since 1975. In an attempt to ensure the continuation of preferential market access after the expiration of the WTO ACP waiver in December 2007, the EU proposed negotiations on comprehensive, reciprocal EPA. In December 2008 the EU signed an EPA with the CARIFORUM group of countries,[65] whose goal is the progressive, reciprocal and asymmetric liberalization of services and investment. Title II on "Investment, Trade in Services and E-commerce" contains, among others, rules for national treatment, market access and transparency. Chapters 2 and 3 address commercial presence (mode 3) and

[65] Economic Partnership Agreement between the CARIFORUM member States and the European Communities and its member States, 15 October 2008, signed by the EU 27 and Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti (signed in 11 December 2009), Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Surinam, and Trinidad and Tobago.

cross-border supply of services (mode 1 and 2) respectively. At the same time, other ACP countries have signed a total of six interim agreements[66] and negotiations for a further six comprehensive EPAs are currently ongoing.[67]

The EU is currently negotiating an Association Agreement with MERCOSUR, and with Central America which aim at creating free trade areas between each of the two blocs. Other preferential agreements signed by the EU with third countries include the association agreements within the Euro-Med partnership and the Economic Partnership Agreement with the CARIFORUM states signed in 2008. Liberalization of trade in services and investment, including the right of establishment, is among the key objectives in these agreements.

[66] Southern African Development Community, June 2009 (Botswana, Lesotho, Swaziland, Mozambique; signature from Namibia is pending; South Africa and Lesotho have decided to refrain from joining); East African Community, November 2007 (Burundi, Kenya, Rwanda, Tanzania, Uganda); Eastern and Southern Africa, November and December 2007 (Comoros, Madagascar, Mauritius, Seychelles, Zimbabwe) and August 2009 (Zimbabwe); Pacific, October and December 2009 (Papua New Guinea, Fiji); Cote d'Ivoire, November 2008; Ghana (signature pending);Cameroon, January 2009.

[67] Negotiations towards a full EPA continue with West Africa (the Economic Commission of Western African States), Central Africa, the East African Community, Eastern and Southern Africa, SADC and the Pacific region.

ANNEX 7

Summaries of selected Dispute Settlement Cases (Module 3)

Vacuum Salt Products Limited
vs The Republic of Ghana
(ICSID Case No. ARB/92/1)
Corporate nationality

The problem of the definition of the investor is accurate especially with issues of corporate nationality. Host States laws often require that entry of foreign investment is realized through locally incorporated vehicles. In the situation of such incorporation, the locally incorporated vehicle becomes a company of the host State.

Requirement of Art. 25(2)(b) of the ICSID Convention: "[...] and any juridical person which had the nationality of the Contracting State party to the dispute on that date and which, because of foreign control, the parties have agreed should be treated as a national of another Contracting State for the purposes of this Convention."

Facts:

- Vacuum Salt, Inc. was incorporated in Ghana pursuant to Ghanaian laws. Initial investment was realized by a Greek national. Originally, the Greek investor controlled all the shares, but then transferred them to a Ghanaian national so that he was not anymore a majority shareholder. A lease agreement containing the right to develop a salt production and mining facility in Ghana was established between the two parties.
- A dispute arose with the Government of Ghana. The agreement contained a clause providing submission of "disputes arising out of or in connection with the agreement" to the ICSID Convention.

Legal questions:

- Is the ICSID proficient enough to examine the case?
- Can the business be considered as a foreign company?
- In jurisprudence, the existence of an arbitration clause in an agreement is often regarded as a signal to treat the local vehicle as a foreign one for the purpose of the ISCID arbitration.

Arguments of Ghana:

- The jurisprudence should not be followed because the structure of ownership of Vacuum Salt changed fundamentally. At the time of the lease agreement, the Greek national was no longer a majority shareholder (when the claim occurred he possessed only 20% of the shares).

Decision:

- The Tribunal ruled that it was relevant to look at the structure of the company to ascertain its status.
- "The second clause of Art. 25(2)(b) [of the ICSID Convention] must be fulfilled, at least initially, on the date of consent", in this case, when the lease agreement was signed.
- On the issue of "because of foreign control" (c.f. Art. 25(2)(b)) the Tribunal ruled that there is no "material evidence that [the Greek national] either acted or was materially influential in a truly managerial rather than technical or supervisory vein".
- The Tribunal found that it lacked jurisdiction on this subject matter.

Yaung Chi Oo Trading Pte Ltd. (YCO)
vs Government of the Union of Myanmar
(ASEAN I.D. Case No. ARB/01/1)

Facts:

- Following Myanmar legislation, a joint venture was concluded between the YCO (the claimant, a company incorporated in Singapore) and a State owned entity controlled by the Ministry of Industry of Myanmar.
- The dispute arose from an alleged takeover of the beer factory on the premises by the armed Myanmar armed forces.
- YCO had secured a license from the Myanmar authorities for an initial period of 5 years.
- Investments made by ASEAN nationals are protected by the 1987 ASEAN Agreement for the Promotion and Protection of Investments provided that they are "specifically approved in writing and registered by the host country".

Arguments of the parties regarding the 1987 ASEAN Agreement:

- Arguments of YCO: The necessary authorizations had been obtained. The license was sufficient as authorization for purposes of the treaty.
- Arguments of Myanmar: The granting of the licenses was not sufficient. Myanmar is a later adherent to the 1987 ASEAN Agreement so existing investments had to undergo a specific approval again.

Arguments of the parties regarding the 1998 ASEAN Framework Agreement:

- Arguments of YCO: YCO is an "ASEAN investor" so that it has the right of entry and establishment with ASEAN countries under the terms of the Framework Agreement.
- Arguments of Myanmar: the Framework Agreement has only future significance and does not apply to YCO's investment.

Decision:

- The Tribunal ruled that the claimant did not have the specific approval necessary for the invocation of the 1987 Agreement.
- The claimant could not invoke the Framework Agreement, a programmatic treaty.

Conclusion:

- This case illustrates that obtaining admission under domestic law may not be sufficient for treaty protection.
- Conditions may be attached for admission as well as for treaty protection.
- The rationale underlying treaties as to admission and protection are different. The 1987 Treaty was based on protection only. The 1998 Agreement was based also on liberalization of flows of investment.

SD Myers, Inc. vs Government of Canada (NAFTA ARB) National Treatment

Introduction:

- Dispute under Chapter 11 of the NAFTA.
- Whereas EU treaties on investment seek to protect investments, liberalization treaties like the NAFTA concentrate both on the liberalization and the protection of foreign investment.
- In treaties aimed at liberalizing investments: NT has a special significance: it applies at the stage prior to entry as well as the stage after the entry.

Significance at the stage prior to entry:

- It creates a right for foreigners to enter a State and to establish a business.
- No discrimination in regard to entry and establishment between a foreigner and a national of the host State.

Facts:

- SD Myers is a case that deals with NT after entry has been made.
- SD Myers Inc. is a company which provides for PCB (polychlorinated biphenyl) waste remediation. It created a subsidiary in Canada in order to collect PCBs in the Toronto region for disposal at its factory in Ohio, which is much closer than the closest Canadian facility.
- SD Myers was able to offer Canada its services at very cost-effective prices (1/4 to 1/2 of the cost of Canadian competitors).
- The Government of Canada prohibited the export of PCB from Canada to the US for processing.

The Government of Canada had two justifications:

- Prohibition is consistent with the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal.
- The 1986 bilateral agreement between Canada and the US for the transboundary transportation of toxic wastes between Canada and the US was being negotiated.

Arguments of Canada:

- Canada claimed that the regulation was not a measure that related to an investor or an investment in Canada
- Canada said that the prohibition was made because PCBs are a significant danger to health and environment when exported without appropriate assurances of safe transportation and destruction

Arguments of SD Myers, Inc.:

- The regulation by Canada did not comply with its obligations under Chapter 11 of the NAFTA.
- More specifically, the regulation by Canada violated the NT provisions of Chapter 11 of the NAFTA.
- SD Myers alleged that the regulation made by Canada constituted disguised discrimination aimed at SD Myers and its investment in Canada in order to protect Canadian competitors.

Decision:

- The Tribunal found that the prohibition made by the Government of Canada did relate to an investor and its investment.
- It also found that there was a violation of the national treatment standard contained in the NAFTA.
- The Tribunal held on the dispositive provisions: "Canada shall pay SDMI compensation for such economic harm as established legally by SDMI to be directly as a result of Canada's breach of its obligations under Articles 1102 or 1105 of the NAFTA."

Emilio Agustin Maffezini
vs the Kingdom of Spain
ICSID Case No. ARB/97/7
Most-Favoured-Nation Treatment

Facts:

- In the dispute between Mr. Maffezini and the Kingdom of Spain the Tribunal considered the question whether the claimant could rely on a most-favoured-nation clause in order to benefit from a more favourable dispute settlement provision included in another BIT.
- The Argentine national E.A. Maffezini had invested in a corporation producing and distributing various chemical products in Spain. During the process of establishing the corporation, the investment allegedly received treatment from Spanish entities inconsistent with the provisions of the Argentine-Spain BIT. Consequently, Mr. Maffezini initiated arbitration proceedings under ICSID.
- Spain challenged the jurisdiction of ICSID and the competence of the Tribunal, as, according to Article X of the Argentine-Spain BIT, Maffezini should have submitted the case to Spanish Courts before referring it to international arbitration.
- Maffezini invoked the most-favoured-nation clause contained in the Argentine-Spain BIT. He claimed that the Chile-Spain BIT allowed submission of a dispute to arbitration without prior referral to domestic Courts, thus providing a more favourable dispute settlement provision for foreign investors.

Legal questions:

- Under which conditions can a more favourable dispute settlement provision in the BIT with a third country be extended to a claimant on the grounds of a most-favoured-nation clause?
- Article IV(2) of the Argentine-Spain BIT provides for most-favoured-nation treatment.

Decision:

The Tribunal examined the conditions for the application of the MFN clause and concluded:

- If the third party treaty refers to a matter not dealt with in the basic treaty, the MFN clause is not applicable. It can only operate in respect of the same matter envisaged by the basic treaty, here e.g. dispute settlement.
- Although the Argentine-Spain BIT did not provide expressly that dispute settlement is covered by the MFN clause, the Tribunal considered that dispute settlement arrangements are inextricably related to the protection of foreign investors.

The Tribunal also stated that there are some important limits to the application of the MFN clause:

- The beneficiary should not be able to override public policy considerations that the contracting parties might have envisaged as fundamental conditions for the acceptance of their agreement.

Providing examples the Tribunal stated that:

- The requirement of exhaustion of local remedies or the requirement of a final and irreversible choice between submission to domestic Courts or international arbitration cannot be bypassed by invoking the MFN clause.
- The requirement for the prior resort to domestic Courts required in the Argentine-Spain BIT did not, however, reflect a fundamental question of public policy.
- Accordingly, the Tribunal concluded that Maffezini had the right to submit the dispute to arbitration without first accessing the Spanish Courts by relying on the MFN clause. The Tribunal affirmed the jurisdiction of the centre and its own competence in the case.

As a general remark, the Tribunal stated that a distinction had to be made between:

- The legitimate extension of rights and benefits by means of the MFN clause.
- Disruptive treaty-shopping that would wreak havoc with policy objectives of underlying specific treaty provisions.

Mondev International Ltd.
vs United States of America
(NAFTA Case ARB(AF)/99/2)
Fair and Equitable Treatment

Facts:

- Mondev, a Canadian company entered into a contract, through Lafayette Place Associates (LPA) a US company it owned, with the Boston Redevelopment Authority (BRA) for the development of a commercial area.
- A dispute arose out of the contract and was litigated before the Massachusetts Courts, which held that BRA was immune from liability for international torts.
- On 31 July 2001 the NAFTA Free Trade Commission adopted an interpretation of Article 1105 affirming that the fair and equitable treatment and full protection and security principles do not require treatment in addition to or beyond that required by customary international law minimum standards of treatment of foreigners.

Arguments:

- Mondev filed a NAFTA claim arguing that the Courts of Massachusetts, by refusing remedies had violated NAFTA Article 1105 on fair and equitable treatment.
- The NAFTA Free Trade Commission interpretation was a revision of the provision Article 1105 of NAFTA and should not be accepted.

Legal questions:

- Does the fair and equitable treatment principle of Article 1105 require treatment more favorable than that provided for by the customary minimum standard of treatment of foreigners principle?

Decision:

- The Tribunal noted that the interpretation of the Free Trade Commission was in accordance with the intention of the parties as well as with the practice of other States.
- What was contested was not the acts of the Executive, but the reasoned judgements of the Courts of a State. In such a situation the standard is violated only if there is a justified concern as to the judicial correctness of the outcome.
- The Tribunal was reluctant to characterize the grant of immunity by the Massachusetts Courts as a denial of justice
- It argued that faced with a legislation that granted such immunity, the Courts had no option but to grant it.
- The Tribunal held that the Court's decision could not amount to a denial of justice or a violation of an international minimum standard of treatment.

Metalclad Corporation vs the United Mexican States

An example on the issue of indirect expropriation is the dispute between Metalclad Corporation and Mexico. The Metalclad case resulted in the first finding of a violation of NAFTA Article 1110 on expropriation.

Facts:

- Metalclad, a US enterprise, purchased the Mexican corporation COTERIN located in the Mexican State of San Luis Potosi in order to build a hazardous waste landfill.
- Having obtained permits and approvals at the federal and the State level, Metalclad began construction. The activity was, however, interrupted when the concerned municipality demanded a construction permit. The municipality interfered mainly due to public protests motivated by ecological concerns.
- Assured by federal and State officials that all necessary permits had been issued, Metalclad applied for the municipal construction permit and resumed construction.
- The municipal construction permit was denied. Moreover, the municipality succeeded in obtaining a judicial injunction which prevented Metalclad from operating the landfill.
- Metalclad initiated arbitral proceedings against Mexico under Chapter 11 of the NAFTA, claiming, *inter alia*, the violation of Article 1110 on expropriation and compensation.

Legal questions:

- Can the act of preventing the operation of the landfill by a municipal authority, given the fact that the federal government approved of the investment project, constitute an expropriation under Article 1110 of the NAFTA?

Decision:

- According to the rules of State responsibility, Mexico is internationally responsible for the acts of State bodies at all levels of government, i.e. also for acts taken by the municipality.
- Expropriation under the NAFTA includes not only open takings of property but also covert or incidental interference with the use of property which has the effect of depriving the owner of the use or economic benefit of its property.
- The municipality prevented the investor's operation of the landfill, notwithstanding the fact that the project was fully approved and endorsed by the federal government.
- By denying the construction permit the municipality acted outside its authority. Furthermore, a timely, orderly or substantive basis for the denial was not provided.
- By permitting or tolerating the acts taken by the municipality in relation to Metalclad, Mexico took a measure tantamount to expropriation and thus violated Article 1110 of the NAFTA.

Conclusion:

- The case of Metalclad raises several issues concerning thelimits of the concept of expropriation;
- whether and to what extent there is scope for regulatory takings. (In this context, the issue of how environmental concerns can be balanced with the notion of protection of foreign investment is of growing significance.)

Barcelona Traction, Light and Power Co. Ltd., Belgium vs Spain (International Court of Justice, ICJ, Reports 1961, 1964 and 1970) State-State Dispute Settlement

Introduction:

- Barcelona Traction was a Canadian joint stock company formed in Canada. A greater part of share capital belonged to Belgian nationals, and its activity was primarily in Spain.
- As a result of measures taken by the Spanish government, Barcelona Traction was adjudicated bankrupt in Spain and later subjected to liquidation measures.
- Canada could not succeed in getting its grievances redressed by Spain.
- Belgium took up the case of its nationals and filed the case before the ICJ, invoking jurisdiction under the Treaty of Conciliation, Judicial Settlement and Arbitration between Belgium and Spain.

Arguments of Belgium:

- In the course of the bankruptcy proceedings the rights of the company were seriously disregarded.
- That the decisions of the Spanish Courts were vitiated by errors in the application of law and by arbitrariness or discrimination, which amounted to a denial of justice damaging the interests of the company and its shareholders.
- Because the company ceased to exist, and since Canada lacked capacity to take action, therefore the only way to protect the shareholders rights was through Belgium exercising diplomatic protection.

Arguments of Spain:

- Spain contested the ICJ jurisdiction on the basis that the re-commencement of the proceedings was contrary to the spirit of the Treaty which Belgium invoked for the jurisdiction of the Court.
- The original jurisdiction, which referred to the Permanent Court of International Justice, was interrupted between 1945 and 1955, when Spain was not a member of the UN.
- Belgium did not have capacity to espouse the claims of its nationals, since they were different from those of the company.
- The Belgian complaint was not admissible given the company's failure to exhaust local remedies.

Decision:

- The Court observed that for a State to bring a claim regarding the treatment of foreign investments, the State must establish its right to do so. In the case, only the company could take action in respect of matters that infringed only its rights.
- Since the company was Canadian it was for Canada to exercise diplomatic protection
- Recognizing a capacity to exercise diplomatic protection of shareholders would open the door to competing claims on the part of different States, which could create an atmosphere of insecurity in international economic relation.

Wena Hotels Limited vs Arab Republic of Egypt (ICSID Case ARB/98/4) Investor-State Dispute Settlement

Introduction:

- The dispute came from an agreement to develop and manage the Luxor and Nile hotels.
- The agreement was between Wena, a company incorporated in the UK and owned by an Egyptian national, and the Egyptian Hotel Company (EHC), a State-owned company.
- The agreement provided that Wena would operate the hotels without EHC interference, and that disputes would be settled through arbitration.

Facts:

- Shortly after entering into the agreement, Wena found the hotels in a condition far below that stipulated, and withheld part of the rent.
- As a result of this action, EHC decided to terminate the two hotel leases. Both hotels were seized by EHC employees.
- The government condemned the seizures as illegal, and ordered the return of the hotels to Wena.
- After the return of the hotels Wena initiated two local arbitration proceedings against EHC for the breach of the leases.
- Both awards granted Wena damages for these invasions and ordered the company to pay its rental obligations. The award on the Nile hotel also requested Wena to surrender the hotel to EHC.
- As a result of the arbitrations Wena was evicted from the Nile Hotel, while the Luxor hotel was placed under judicial receivership after Wena successfully appealed the arbitral award.
- Wena filed for ICSID arbitration claiming a breach of the 1975 Investment Promotion and Protection Agreement (IPPA) between the UK and Egypt.
- According to Wena, consent for arbitration was found in Article 8(1) of the IPPA which

made reference to Article 25(2)(b) of ICSID Convention on the qualification of "national of another contracting party".

Arguments of Wena:

- Egypt had breached Art. 2(2) IPPA, on fair and equitable treatment and full protection and security.
- Egypt's conduct constituted an expropriation in breach of Art. 5(1) of IPPA, and required the payment of prompt, adequate and effective compensation.

Arguments of Egypt:

- Given that Wena was owned by an Egyptian national, the consent to arbitrate found in the IPPA did not apply, because it could not be treated as a national of another contracting State (jurisdiction *ratione personae*);
- The dispute did not directly concern Egypt, but rather was a private dispute between EHC and Wena derived from their contract, and therefore could not be dealt with in ICSID (jurisdiction *ratione materiae*).

Legal questions:

- Whether under Article 8(1) of the IPPA, read in conjunction with Article 25(2)(b) of ICSID, a company incorporated in the UK, but under the control of an Egyptian national, could sue Egypt.
- Whether the dispute was simply between Wena and EHC, or it involved Egypt's responsibility and therefore gave rise to ICSID arbitration.

Decision:

- The Tribunal held that Wena was a company incorporated in the UK and therefore the provisions of the IPPA and the ICSID Convention were satisfied.
- The purpose of those provisions was to allow companies incorporated in one member State and with activities in another member State, to bring forth a claim.

The Tribunal further held that even if Egyptian officials did not participate in the seizure of the hotels, given that:

- Egypt was aware of EHC's intentions but did nothing to prevent it
- The police did nothing to protect Wena's investment
- Egypt, by not sanctioning EHC officials, suggested its approval of EHC's actions;
- Egypt refused to compensate Wena for its losses.
- It could be established that Egypt had failed to provide full protection and security to Wena's investments, and therefore constituted a breach of the IPPA obligations, and gave rise to jurisdiction under ICSID.

ANNEX 8

Summaries of selected Dispute Settlement Cases (Module 4)

WTO Dispute Settlement Body
Mexico Telecoms vs United States
Panel Report 2004

Facts:
On 17 August 2000, the US requested consultations with Mexico in regards to Mexico's commitments and obligations under the GATS with respect to basic and value-added telecommunications services. According to the US since the entry into force of the GATS, Mexico adopted or maintained anti-competitive and discriminatory regulatory measures, tolerated certain privately-established market access barriers, and failed to take needed regulatory action in Mexico's basic and value-added telecommunications sectors. The US claimed that Mexico had, for example:

- Enacted and maintained laws, regulations, rules, and other measures that deny or limit market access, national treatment, and additional commitments for service suppliers seeking to provide basic and value-added telecommunications services into and within Mexico;
- Failed to issue and enact regulations, permits, or other measures to ensure implementation of Mexico's market access, national treatment, and additional commitments for service suppliers seeking to provide basic and value-added telecommunications services into and within Mexico;
- Failed to enforce regulations and other measures to ensure compliance with Mexico's market access, national treatment, and additional commitments for service suppliers seeking to provide basic and value-added telecommunications services into and within Mexico;
- Failed to regulate, control and prevent its major supplier, Teléfonos de México ("Telmex"), from engaging in activity that denies or limits Mexico's market access, national treatment, and additional commitments for service suppliers seeking to provide basic and value-added telecommunications services into and within Mexico; and
- Failed to administer measures of general application governing basic and value-added telecommunications services in a reasonable, objective, and impartial manner, ensure that decisions and procedures used by Mexico's telecommunications regulator are impartial with respect to all market participants, and ensure access to and use of public telecommunications transport networks and services on reasonable and non-discriminatory terms and conditions for the supply of basic and value-added telecommunications services.

The US considered that the alleged action and inaction on the part of Mexico was inconsistent with Mexico's GATS commitments and obligations, including Articles VI, XVI, and XVII; Mexico's additional commitments under Article XVIII as set forth in the Reference Paper inscribed in Mexico's Schedule of Specific Commitments, including Sections 1, 2, 3, and 5; and the GATS Annex on Telecommunications, including Sections 4 and 5.

On 10 November 2000, the US requested the establishment of a panel. On the same date, the US sent a request to the DSB for consultations concerning several recent measures adopted by Mexico affecting trade in telecommunication services. At its meeting on 12 December 2000, the DSB deferred establishment of a panel. On 13 February 2002, the US requested the establishment of a panel. In particular, the US claimed that Mexico's measures had:

- Failed to ensure that Telmex provides interconnection to US cross-border basic telecom suppliers on reasonable rates, terms and conditions;
- Failed to ensure US basic telecom suppliers reasonable and non-discriminatory access to and use of public telecom networks and services;
- Did not provide national treatment to US-owned commercial agencies; and
- Did not prevent Telmex from engaging in anti-competitive practices.

At its meeting on 8 March 2002, the DSB deferred the establishment of a panel. Further to a second request by the US, the DSB established a panel at its meeting on 17 April 2002. Canada, Cuba, the EC, Guatemala, Japan and Nicaragua reserved their third-party rights to participate in the proceedings. On 18 April 2002, India joined as a third party to the dispute. On 19 April 2002, Honduras joined as a third party to the dispute. On 23 April 2002, Australia joined as a third party. On 24 April 2002, Brazil joined as a third party. On 16 August 2002, the US requested the Director General to determine the composition of the panel. On 26 August 2002, the panel was composed.

On 13 March 2003, the Chairman of the Panel informed the DSB that it would not be possible to complete its work in six months due to the time needed for translation into Spanish and English of all relevant documents and the complexity of the issues involved. The panel expected to complete its work in August 2003. On 6 August 2003, the Chairman of the Panel informed the DSB that the panel expected to complete its work in December 2003.

Decision:
On 2 April 2004, the panel report was circulated to members. The panel ruled that Mexico violated its GATS commitments because:

- Mexico failed to ensure interconnection at cost-oriented rates for the cross-border supply of facilities-based basic telecom services, contrary to Article 2.2(b) of its reference paper.
- Mexico failed to maintain appropriate measures to prevent anti-competitive practices by firms that are a major telecom supplier, contrary to Article 1.1 of its reference paper.
- Mexico failed to ensure reasonable and non-discriminatory access to and use of telecommunications networks, contrary to Article 5(a) and (b) of the GATS Annex on Telecommunications.
- With respect to cross-border telecom services supplied on a non-facilities basis in Mexico, however, the panel ruled that Mexico did not violate its obligations because it had not taken commitments for these services.

On 1 June 2004, the DSB adopted the panel report.

Implementation status:
On 1 June 2004, Mexico and the US reached an agreement regarding Mexico's compliance with the recommendations of the panel report. The agreement stated that a reasonable period of time to comply with the recommendations of the report is 13 months.

Consortium Groupement L.E.S.I.–DIPENTA vs Algeria (ICSID Case No. ARB/03/8)

Facts:
The dispute arose out of a concession agreement granted in December 1993 by the Agence Nationale des Barrages (ANB) to the Italian companies L.E.S.I. and DIPENTA (organized under a consortium) for the construction of a dam in the region of Wilaya of Bouira, Algeria. According to the consortium, the execution of the concession encountered various problems mainly due to the region's lack of security. In 1997, the ANB modified the project and requested a new type of dam which required new financing and the approval of the original financing institution, the African Development Bank. In 2001, the ANB terminated the concession agreement for force majeure, due to the African Development Bank having requested a new international tender. The ANB agreed to offer some compensation to the consortium, but the parties failed to agree on the amount and no payment had ever been made.

On February 3, 2003, the consortium, registered in Rome, Italy, brought a request for arbitration against Algeria on the basis of the ICSID arbitration clause contained in the 1991 bilateral investment treaty (BIT) between Italy and Algeria. The request was registered on May 20, 2003. The parties agreed that the arbitral Tribunal would consist of three arbitrators, one arbitrator appointed by each party and the third and presiding arbitrator appointed by the co-arbitrators.

Arguments:
The consortium asked the Tribunal to declare that Algeria had breached its obligations under the BIT by not promoting, protecting and affording security to the consortium's investment; by applying discriminatory measures against it; and by illegally expropriating it.

Algeria raised objections to jurisdiction and admissibility (fins de non recevoir). It argued that:
- The conditions required under Article 25(1) of the ICSID Convention had not been fulfilled.
- Jurisdiction should be limited to the violations of the BIT, if any.
- The consortium did not have standing.
- The conditions for the consent under the BIT had not been met.

Regarding the involvement of a contracting State, Algeria argued that the dispute exclusively involved ANB as opposed to the Algerian State.

Decision:
On the objection to jurisdiction related to Article 25(1) of the ICSID Convention, the Tribunal examined the four conditions set forth by that provision, i.e., that:

- There was a legal dispute;
- Arising directly out of an investment;
- Between a contracting State and a national of another contracting State;
- That there was consent in writing from the parties to submit the dispute to the centre.

With respect to the first condition, the Tribunal decided that a dispute existed regarding the amount of compensation alone, and that it was a legal dispute (Part II, paras. 8 and 9).

Regarding the notion of investment, the Tribunal considered that a construction contract would constitute an investment if three criteria were met:

- The contracting party made contributions in the host country.
- These contributions had a certain duration.
- They involved risks for the contributor.

The Tribunal added that it was not required to determine the operation's significance for the host State's economic development as this was difficult to ascertain and as it was implicitly covered by the three other criteria. On these criteria, the Tribunal specified that contributions were not limited to financial commitments and did not necessarily need to be made exclusively in the host country. The Tribunal stated that contributions could partly be made in the home country on the condition that they were allocated to the project to be carried out in the host country. The Tribunal further considered that the notion of duration should be broadly apprehended as long as there were economic commitments of a high value. The Tribunal therefore concluded that in the present case there was an investment (Part II, paras. 13-15).

The Tribunal stated that at the jurisdictional stage, its role was limited to a formal control that the claims were brought against a State, unless it was obvious that there was no link between the underlying contract and the State. The Tribunal recalled that States could be liable for contracts entered into by independent public entities as long as they could exercise their authority over the said entity.

The Tribunal considered that, without prejudice to findings on the merits, the dispute was against a State, as the Algerian State participated, at least indirectly, in the negotiations of the contract and had a strong influence on the ANB's decision process (Part II, paras. 19 and 20).

Regarding the issue of Algeria's written consent to submit the particular dispute to ICSID, the Tribunal analyzed the relevant provisions of the BIT. In this context, Algeria argued that there was no investment covered under the BIT, since for an investment to be made in accordance with the laws and regulations in force, it needed to follow specific procedures. The Tribunal rejected that argument on the principal ground that an international treaty should be interpreted in consideration of the meanings given by both State parties as opposed to a meaning based on one of the State party's domestic laws. The Tribunal concluded that Algeria had given its written consent, which covered the investment at hand (Part II, para. 24).

However, examining further the scope of Algeria's consent and the second objection to jurisdiction, the Tribunal concluded that the consent was limited to measures which would constitute a breach of the BIT's provisions. The Tribunal reached that conclusion on the basis of the drafting of the BIT, which did not contain any "umbrella clauses" (Part II, paras. 25 and 26).

Having concluded that it had jurisdiction to decide on the consortium's claims based on a violation of the BIT provisions, the Tribunal examined the objections to admissibility. It first addressed the question of whether the consortium had attempted to settle the dispute amicably and had respected a cooling-off period of six months before bringing forward the request for arbitration, as provided by the BIT. The Tribunal concluded that the consortium had complied with this requirement. It considered that the six-month period should be calculated from the date of the first written request to settle amicably made by the consortium, which officially explained the claims to Algeria, and that such request need not be drafted in a specific way. The Tribunal further stated that this cooling-off period was not an absolute condition when it was obvious that any conciliation attempt would be doomed given the State party's behaviour (Part II, paras. 32 and 33).

Regarding the issue of the consortium's standing, the Tribunal noted that the concession agreement was originally signed by a "temporary" or "informal consortium" consisting of the two Italian companies L.E.S.I. and DIPENTA. It was only after the Italian companies were granted the bid that they formally registered as a consortium. However, the Tribunal found that the ANB was never clearly informed of this substitution and, hence, never approved it. The Tribunal considered that under Italian law the registered consortium was an autonomous legal entity, independent of the two companies which were composing it. As such, the consortium never benefited from the rights of the concession agreement and it could not therefore make any claim in its respect, since the request was brought by the registered consortium on its own behalf, it had no standing. In the absence of such standing, the consortium could not be considered as an investor pursuant to Article 25(1)of the ICSID Convention and therefore the Tribunal concluded it lacked jurisdiction (Part II, paras. 37-41). The Tribunal was aware of the inconvenience triggered by such a decision since a new request for arbitration would have to be brought by the Italian companies on their own behalf. However, the Tribunal pointed out that this solution would have the advantage of clarifying the situation and would eliminate potential grounds for recourse against the eventual award (Part II, para. 40(i)).

The arbitral Tribunal unanimously declined jurisdiction on the ground that the Consortium Groupement L.E.S.I.–DIPENTA did not have standing. As the consortium had no standing, the Tribunal considered it unnecessary to address the alleged breach by the consortium of Article 26 of the ICSID Convention for having sued ANB before an Algerian Administrative Court (Part II, para. 42).

On the question of costs, the Tribunal decided that the arbitration costs should be shared equally and that each party should bear its own expenses since most of Algeria's objections were rejected except for the one related to the consortium's standing (Part II, para. 43).

Following the Tribunal's award, the two Italian companies (L.E.S.I. and Astaldi S.p.A, which bought DIPENTA) jointly brought a new request for arbitration, which was recently registered.

A. Ahlström Osakeyhtiö vs Commission (Wood Pulp) European Court of Justice, ECJ, Cases 89/85, 114/85, 116-117/85, 125-129/85, Decision of 27 September 1988 (not yet reported)

Facts:
A number of Finnish, Swedish, American and Canadian wood pulp producers established outside the EC created a price cartel, eventually charging their customers based within the EC. On December 19, 1984, the commission issued a decision3 establishing several infringements of Article 85 of the treaty.

Arguments:
The principal arguments of the commission justifying the community's jurisdiction to apply their competition rules to an undertaking outside the community were as follows: the producers involved were exporting and selling directly to customers in the EC or they were doing business within the community through branches, subsidiaries or other agents. Not less than two-thirds of the total shipment and 60% of the consumption of wood pulp in the community had been affected by the alleged restrictive practices.

Eleven of the forty addressees of the commission decision brought an action for annulment of the decision. They had two main arguments, one based on community law, the other on international law. First, the commission's construction of Article 85 of the treaty was challenged and, second, even if the conditions of Article 85 were fulfilled, it would be contrary to international law to regulate conduct restricting competition adopted outside the territory of the community merely by reason of the "economic repercussions" produced within the EC. The American and Canadian applicants further claimed that the application of EC competition rules in these circumstances would constitute a breach of the general principle of non-interference and that the community, by imposing fines, had infringed Canada's sovereignty and had breached international comity. Finally, the Finnish undertakings raised the special argument of the Free Trade Agreement concluded between the EC and Finland which by virtue of its Articles 23 and 27 would preclude the community from applying EC competition law.

Decision:
Compared to the commission's decision and the Advocate General's opinion, the judgement of the Court was remarkable in its quick decision, which inevitably gave rise to different interpretations and raised additional questions. As for community law, the Court upheld the territorial scope of Article 85 of the treaty as construed by the commission. Article 85 prohibits all agreements or concerted practices between undertakings "which may affect trade between member States and which have as their object or effect the prevention, restriction, or distortion of competition within the common market."

The Court started by stating the fact that as the producers involved in the case were the main source of supply of wood pulp they would constitute the principal actors of competition within the community. They then stated that it is clear the producers had decided in concert on the prices to be charged to their customers in the community and by putting that decision into effect and selling at prices which were actually coordinated, they were taking part in concertation which has the object and effect of restricting competition within the common market under the meaning of Article 85 of the treaty.

From this, it must be concluded that by applying the competition rules in the treaty in the circumstances of this case to undertakings whose registered offices are outside the community, the commission has not made an incorrect assessment of the territorial scope of Article 85.

With regard to the question of compatibility of the decision with public international law the Court drew up a distinction between the formation of the concerted practice and its implementation. The application of Article 85 depended not on the place where the agreement at issue was concluded but solely on the place where the agreement was implemented.

It should be observed that an infringement of Article 85, such as in the conclusion of an agreement which has had the effect of restricting competition within the common market, consists of conduct made up of two elements, the formation of the agreement, decision or concerted practice and the implementation thereof...

The producers in this case implemented their pricing agreement within the common market. It is immaterial in that respect whether or not they had recourse to subsidiaries, agents, sub-agents, or branches within the community in order to make their contracts with purchasers within the community.

Accordingly the community's jurisdiction to apply its competition rules to such conduct is covered by the territoriality principle as universally recognized in public international law.

The Court left open the question whether or not a rule of non-interference actually exists in public international law. The Court also did not see any contradictory duties deriving from differences between community law and American law, in particular, from the Webb-Pomerene Act, which exempts export cartels from US antitrust laws but does not require the formation of such cartels.

This question was submitted by the American applicants, who referred to the concurring opinion of Judge Fitzmaurice in the case of Barcelona Traction Light & Power Company, which described non-interference as a rule according to which two States have jurisdiction to lay down and enforce rules and the effect of those rules is that a person finds himself subject to contradictory orders as to the conduct he must adopt, each State is obliged to exercise its jurisdiction with moderation.

Ultimately, the Court quickly rejected the argument from international comity calling for prior disclosure to the States affected. The Court established that as the community's jurisdiction does not contravene, international law comity cannot be said to have been violated.

As far as the Finnish producers are concerned, the Court had to consider, in a more specific field of international law, the relationship between community law and the provisions of the Free Trade Agreement between Finland and the EC. Article 23 paragraph 1 of that agreement states that agreements or concerted practices which have as their object or effect the restriction of competition are incompatible with the proper functioning of the agreement insofar as they may affect trade between the EC and Finland. Article 23 paragraph 2 and Article 27 paragraphs 2 and 3 of the agreement set forth a special bilateral procedure within the Joint Committee to be followed before the parties to the agreement can take measures against the restricting practices.

The Court argued in two steps. Articles 23 and 27 of the agreement presuppose that the parties to the agreement have rules enabling them to proceed against practices incompatible with Article 23.

As far as the community is concerned, those rules can only be the provisions of Articles 85 and 86 of the treaty. The application of these articles is therefore not precluded by the Free Trade Agreement.

The decisive reason, however, seems to be that the matter at issue is not a bilateral one concerning solely Finnish-EC trade. It is not bilateral trade, which is affected, that constitutes the condition of Article 23 of the Agreement. It is intra-Community competition that is distorted by a concerted practice on a much larger scale including not only Finnish but also Swedish, American, and Canadian producers.

It should be noted that in this case the community applied its competition rules to the Finnish applicants not because they had concerted with each other but because they took part in a very much larger concertation, which restricted competition within the community. It was thus not just trade with Finland that was affected. In that situation reference of the matter to the Joint Committee could not have led to the adoption of appropriate measures.10

After considering these arguments the Court held that the decision at issue is covered by Article 85 of the EEC Treaty and does not infringe public international law or the Free Trade Agreement. On the merits of competition law the Court assigned the case to a Chamber of the Court.

Canada vs European Communities and their member States (Pharmaceutical Patents)

Facts:
On December 19, 1997 the EC requested consultations with Canada with regard to the alleged lack of protection of inventions by Canada in the area of pharmaceuticals under the relevant provisions of the Canadian implementing legislation, in particular the Patent Act. The EC alleged that Canada's legislation was not compatible with its obligations under the TRIPS Agreement, because it does not provide for the full protection of patented pharmaceutical inventions for the entire duration of the term of protection envisaged by Articles 27.1, 28 and 33 of the TRIPS Agreement.

On November 11, 1998, the EC requested the establishment of a panel. At its meeting on November 25, 1998, the Dispute Settlement Body deferred the establishment of a panel. Further to a second request to establish a panel by the EC, the DSB established a panel at its meeting on February 1,1999. Australia, Brazil, Colombia, Cuba, India, Israel, Japan, Poland, Switzerland, Thailand and the United States reserved their third-party rights. On March 15, 1999, the EC and their member States requested the Director-General to determine the composition of the panel. On March 25, 1999, the panel was composed. The report of the panel was circulated to members on March 17, 2000. The panel found that:

- The regulatory review exception provided for in Canada's Patent Act (Section 55.2(1)) – the first aspect of the Patent Act challenged by the EC – was not inconsistent with Article 27.1 of the TRIPS Agreement and was covered by the exception in Article 30 of the TRIPS Agreement and therefore not inconsistent with Article 28.1 of the TRIPS Agreement. Under the regulatory review exception, potential competitors of a patent owner are permitted to use the patented invention, without the authorization of the patent owner during the term of the patent, for the purposes of obtaining government marketing approval, so that they will have regulatory permission to sell in competition with the patent owner by the date on which the patent expires.

- The stockpiling exception (Section 55.2(2)) – the second aspect of the Patent Act challenged by the EC – was inconsistent with Article 28.1 of the TRIPS Agreement and was not covered by the exception in Article 30 of the TRIPS Agreement. Under the stockpiling exception, competitors are allowed to manufacture and stockpile patented goods during a certain period before the patent expires, but the goods cannot be sold until after the patent expires. The panel considered that, unlike the regulatory review exception, the stockpiling exception constituted a substantial curtailment of the exclusionary rights required to be granted to patent owners under Article 28.1 to such an extent that it could not be considered to be a limited exception within the meaning of Article 30 of the TRIPS Agreement.

Decision:
The DSB adopted the panel report at its meeting on April 7, 2000.

Implementation status:
Pursuant to Article 21.3 of the DSU, Canada informed the DSB on April 25, 2000 that it would require a reasonable period of time in order to implement the recommendations of the DSB. Since the parties failed to reach a mutually satisfactory solution as to the "reasonable period of time" for implementation of the recommendations of the DSB, despite a mutually agreed extension of the period of time foreseen in Article 21.3(b) of the DSU, on June 9, 2000, the European Communities and their member States requested that the reasonable period of time be determined by arbitration pursuant to Article 21.3(c) of the DSU. The arbitrator determined, pursuant to Article 21.3 of the DSU, that the reasonable period of time for Canada to implement the recommendations and rulings of the DSB is six months from the date of adoption of the panel report and that the reasonable period would thus end on October 7, 2000. At the DSB meeting of October 23, 2000, Canada informed members that, effective from October 7, 2000, it had implemented the DSB's recommendations.

Técnicas Medioambientales Tecmed, S.A. vs United Mexican Status (Case No. ARB (AF)/00/2)

Facts:
In August 2000, Técnicas Medioambientales Tecmed, S.A. (TECMED), a company incorporated in Spain, submitted before the centre a request for arbitration against the United Mexican States (Mexico). The request invoked the dispute settlement clause contained in the bilateral investment treaty between Mexico and Spain and was administered under the ICSID Arbitration (Additional Facility) Rules.

On February 6, 1996, TECMED acquired through a bid procedure the land, buildings and other assets to operate a hazardous waste landfill in Hermosillo, Sonora, Mexico. The dispute concerned

Mexico's denial in November 1998 of a license renewal for the operation of this hazardous waste landfill. TECMED brought a claim pursuant to the BIT for alleged violations by Mexico of the BIT provisions regarding expropriation, fair and equitable treatment and full protection and security.

Arguments:
The two main preliminary questions raised by the respondent were the jurisdiction ratione temporis of the Tribunal and the three-year time limitation to file a claim provided in the BIT (similar to the one provided in NAFTA).

Regarding the jurisdiction ratione temporis of the Tribunal, the respondent argued that the BIT did not apply to the conduct of the respondent, which predated the entry into force of the treaty. The Tribunal first considered the wording of the treaty and pointed out that, although the treaty covered investments that existed prior to the entry into force of the treaty, the substantive obligations were drafted as projected into the future.

Decision:
According to the Tribunal, this made the retroactive application of those substantive obligations impossible. In that regard, the Tribunal dismissed the claimant's argument in connection to the most-favoured-nation (MFN) clause, indicating that such a principle could not be applicable to questions related to the ratione temporis application of the treaty. However, the Tribunal further stated that this conclusion did not mean that conduct that predated the entry into force of the treaty might not be relevant, if pursuant to Article 28 of the Vienna Convention on the Law of Treaties, the conduct continued to occur or to exist after the entry into force of the treaty.

Regarding the time limitation for filing a claim under the BIT, the Tribunal found that this defense did not concern the competence of the Tribunal but the admissibility of some claims. It further indicated that the cut off date of the three-year limitation period was not relevant, because the claims that predated the cut-off date were already excluded from the competence of the Tribunal by its previous findings.

With respect to the merits of the case, the Tribunal first examined the question of an alleged expropriation under the BIT and admitted the claim.

The claimant's key contention was that the Mexican authorities, by denying the renewal of the license to operate the landfill, expropriated its investment, causing damages to TECMED. The Tribunal first analyzed the expression "tantamount to expropriation" or "indirect expropriation," pointing out the absence of a relevant definition in the BIT. It considered that a measure could be a de facto indirect expropriation by its effects when the measure was adopted by the State, whether being of a regulatory nature or not, was permanent and irreversible, and the assets and rights object of such a measure were affected in such a way that it was impossible to exploit such assets and rights, thus depriving them of any economical value. It also stated that a regulatory measure could be an indirect expropriation by its characteristics when there was a lack of proportionality between the measure, the interest sought to be protected by such a measure and the protection of the investment, and as a result the economic value of the investment was destroyed.

After analyzing in detail the facts of the case, the Tribunal, concluded that the decision of the Mexican authorities was:

- By its effects a de facto indirect expropriation, i.e., the investment was permanently deprived of economic value and could not be exploited; and
- By its characteristics was also an indirect expropriation, i.e., the means used by the Mexican authorities did not keep a reasonable proportionality between the interest protected (the environment) and the protection of the investor's rights (TECMED was actually deprived of operating the landfill and lost thereby its investment).

The Tribunal pointed out the lack of proportionality between the interest pursued and the permanent loss of the economical value of the claimant's investment.

In this regard, the Tribunal considered the following facts:

- Although TECMED had committed breaches to the environmental regulations,68 the Mexican authorities at the time of the breaches considered them as minor.
- The social opposition69 to the operation of the landfill never amounted to a social unrest.
- TECMED had agreed to relocate the landfill and was waiting for new land that the Mexican authorities would provide.

The Tribunal finally concluded that the respondent by expropriating de facto the claimant's investment and not paying an adequate compensation violated Article 5(1) of the BIT.

68 For example, after an inspection conducted by the Administrative Authorities, TECMED paid some fines, because TECMED had breached security regulations regarding the disposal of hazardous material. The fines did not amount, however, to the maximum amount provided in the relevant regulations.

69 Some civil demonstrations occurred against TECMED when operating of the landfill during 1997 and 1998.

The Tribunal then examined the question of an alleged violation of the standard of fair and equitable treatment under the BIT. The Tribunal explained that the fair and equitable treatment standard was based on the principle of good faith, and therefore that provision implied that the conduct of the State needed to be coherent, without ambiguities and transparent in relation to the investor. The Tribunal found that the conduct of the Mexican authorities violated that provision, pointing out, in particular, that they had acted in a contradictory way, by reassuring TECMED that they could operate the landfill until the relocation was conducted and that new land would be provided together with licenses to operate the new landfill, and then denying the renewal of the license.

The Tribunal dismissed the claim regarding the alleged violation of the provision on full protection and security and non-discriminatory treatment. The Tribunal considered that Mexico acted in an appropriate way in connection with the demonstrations by the public against the operation of the landfill by TECMED. It further indicated that the full protection and security guarantee was not absolute and did not impose strict responsibility on the State.

The claimant requested damages in the amount of US$52 million, plus interest. The Tribunal awarded US$5.5 million in damages, and based its calculation on the market value of the landfill at the time of purchase, adding the amounts invested and the value of two years of operation. The Tribunal granted interest at an annual rate of 6% from November 1998, and also ordered the claimant to transfer the property of the landfill, and all the assets related to it, to the respondent after the payment of the damages awarded.

On the question of costs, the Tribunal decided that the costs of the arbitration should be shared equally and that each party should bear its own expenses, since neither party completely succeeded in its contentions.

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