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## Investment

## A Southern Agenda on Investment? Promoting Development with Balanced Rights and Obligations for Investors, Host States and Home States

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### Investment and development

The linkages between investment and development – and sustainable development – are so strong as to be self-evident. In a market economy, investment determines the pace, direction and strength of development. Countries with insufficient investment have little prospect of development; countries that are developing strongly are characterised by vigorous investment.

Foreign investment is a necessary part of the investment universe in most countries. Even in developing countries that are not as constrained by lack of capital as others (South Africa, for example) the entry of foreign investment is important because it brings in foreign investors and creates economic links with the global economy and with the economies of these investors' home countries. The resulting benefits have been documented extensively.<sup>1</sup>

Public authorities in most jurisdictions seek to attract investors, including foreign investors. Attracting investment has, however, proven to be an uncertain art. Based on extensive analysis, there is consensus concerning numerous necessary conditions to attract investors.<sup>2</sup>

Yet linkages between foreign direct investment (FDI) and development are less straightforward than might be supposed. More is not necessarily better, yet there are hardly any attempts to establish qualitative distinctions between investments, including FDI, which can be driven by various factors and can take many forms. The relative weight of these factors will vary according to the aims of the investor, and the financial aspects and circumstances of the host country, always seen in compari-

son to competing opportunities for investment. Investment can be market-seeking, designed to supply a market that cannot be as effectively supplied in any other manner; it can be resource-seeking, designed to capture certain natural resources that are not as available elsewhere; or it can be efficiency-seeking, utilising dimensions of a location's competitive advantage – wages, skilled labour, natural resources or access to transportation, for example.

Certain investments, in particular those that are resource-seeking or that have exceptionally elevated rates of return, may be made almost irrespective of issues of governance, while other investments, where returns are robust but comparatively uncertain, will not be made under any circumstances. There are jurisdictions that exhibit all the characteristics of good governance and attract no foreign investment, just as some jurisdictions with a reputation for poor governance still attract investment.

The number and variety of factors that influence FDI decisions are confusing and render any simple approach to foreign investment problematic. IIAs that promote investment that supports the development objectives of the host country must reflect the full range of factors in an appropriate manner.

Certain foreign investments may crowd out domestic investment, leaving the host country with additional external obligations but no measurable domestic benefits. Other investments, particularly in services, are likely to create balance-of-payments pressures, as foreign investors have a higher propensity to work with familiar (foreign) suppliers, thereby increasing imports without a corresponding increase in exports; and profits from service invest-

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ments additionally burden the balance of payments when they are repatriated, since there are no balancing exports to generate foreign currency.<sup>3</sup>

It is clear that development benefits associated with FDI do not accrue automatically. Not all FDI contributes to economic growth, and even FDI that contributes to growth may not support the development priorities of host countries. For this to change, developing countries believe that the linkage between FDI and development must be explicit and supported by policies that promote desired outcomes, even while they recognise the fundamental economic requirements associated with any investment. Such policies are not easy to craft and not easy to implement. IIAs should be specifically designed to support them.

The need for domestic policies to ensure that development benefits flow from FDI is further accentuated when seeking to promote sustainable development, which brings an additional set of policy priorities into play. It is nonetheless essential if there is to be any prospect of moving towards a more sustainable society.

Many of the required policies are within the scope of normal governmental activity in host countries; they do not depend on international agreements. There is, however, a continuing risk that international investment agreements can get in the way of necessary measures, in particular when they fail to explicitly recognise the need for such measures. Beyond this defensive concern there is the obvious desire to see international investment agreements make a positive contribution to development and sustainable development. This applies particularly in countries that lack some of the vital capabilities to determine the viability of FDI, for example institutional resources, sufficient information to make necessary decisions, the financial means to support such decisions when appropriate, or the legal and administrative tools to ensure that investments are sustainable in the local environment. Consequently, the challenge is to craft international investment agreements that promote a proper balance between investor rights and the sustainable development goals of host and home countries.

## International investment agreements

More than 2,000 international investment agreements (IIAs) exist, yet their purpose remains singularly limited to protecting foreign investors while ignoring many other critical aspects of the relationships surrounding FDI.<sup>4</sup> Most of these agreements pursue this goal using absolute standards of treatment ('fair and equitable treatment' or 'expropriation') or relative standards ('national treatment' or 'most-favoured-nation treatment') to achieve this objective. They provide protection to investors after an investment has been made, particularly from expropriation and access to international investor-state dispute settlement. Promoters of these agreements have argued that the effect of such protection will be the promotion of additional investment between the parties but there is scant evidence to show that they have had a measurable effect.<sup>5</sup>

Some international investment agreements also include rules governing the pre-establishment phase of investments; imposing limits on the use of so-called performance requirements (specified actions required of foreign investors as a condition of authorising the establishment of an investment), and may even initiate a process of 'liberalisation' regarding the right to establishment, for example by identifying certain sectors in which foreigners may invest as of right. There is often an assumption that the list of covered sectors can be expanded through subsequent negotiation between the parties. In a few instances, the agreement will articulate the principle of free access (notably within the European Union), subject to a list of excluded sectors. It is worth noting that 'liberalisation' applies only to pre-establishment rules; post-establishment rules cover all investments that have been made between the parties while the agreement is in force, unless they are specifically limited or balanced by other public interests in an agreement.

Almost all IIAs include one or more parties that are developing countries. Yet few explicitly address the development aspirations of these countries in their statement of purpose.<sup>6</sup> No specific provisions designed to promote development have found widespread use. Freestanding IIAs do not mention sustainable development, a topic broached only

occasionally by trade agreements that include investment provisions.

IAs that make no difference in terms of development or increased investment may be viewed as a harmless exercise in declaratory international relations. Indeed, there is evidence that at least some IAs were concluded as an adjunct to some diplomatic event that required a formal outcome and the signing of an IA appeared harmless when no other option was available. Investment is, however, too important to be the object of such practices. Even seemingly harmless agreements can produce undesirable results. Indeed, it is clear today that IAs do have an impact, albeit not the one their authors may have intended.

Existing IAs fail badly from the perspective of governance for globalisation. They inadequately frame the roles of the key actors in international investment – investors, host states and home states – as well as those of other stakeholders. They hinder the ability of developing countries to exercise some of their most fundamental rights, namely to identify development goals and to pursue public welfare by regulating economic activities. And they impact the capacity of all countries to promote and enact sustainable development policies and measures.

The stated purposes of IAs are important. They help determine the standards by which an agreement and its impacts will be judged. In dispute settlement they provide arbitrators with guidelines for interpretation. More often than not today, the only stated purpose is investment protection and promotion, but substantive treaty provisions only deal with investor protection, leading arbitrators to give priority to this one goal. Frequently, however, a statement of purpose can be used to articulate longer term goals, some of which may currently be unattainable. This creates a framework for arbitrators and an incentive for negotiators to exercise caution and to create opportunities for (rather than obstacles to) subsequent adjustment of agreements to reflect an evolving understanding of what works and what does not.

Little empirical evidence has emerged to support the contention that the treaties that provide investor protection stimulate new and additional flows of foreign direct investment. There is no recog-

nisable relationship between IAs and investment flows. Some countries that are party to no IAs receive significant international investment and many countries that are party to numerous IAs receive almost none. Some countries are not party to investment agreements yet receive investment. Some countries that receive international investment are indeed party to IAs, but the investment does not follow the pattern of agreements in any discernible manner.<sup>7</sup> This is hardly surprising, actually, given the number of factors that condition investment decisions but are not affected by existing IAs. In practice these factors outweigh the impact of existing IAs.

Development is undoubtedly the overriding purpose of developing countries in international economic policy. From a Southern perspective, investment agreements are undesirable if they do not support development. It is hard to argue that existing IAs serve this priority.<sup>8</sup> The substantive provisions of the existing agreements give no visible consideration to the processes and dilemmas of development—or sustainable development for that matter. This is due in part to the uncertainties that surround efforts to ensure that investment promotes development. Yet traditional investment agreements continue to be pursued, and investment provisions are inserted in trade agreements.

No IA by itself can ensure that host countries attain their development goals. That is hardly surprising once it is recognised that IAs are primarily about international governance of investment in a globalised economy. Institutions of governance are designed to promote desirable outcomes, to avoid undesirable ones, and to ensure due process. They can rarely guarantee specific outcomes by themselves. There is a need for a regime for international investment that is characterised by equitable governance at all levels and that meets the most fundamental criteria of legitimacy, transparency and accountability.

### **Necessary conditions for investment for development**

It is appropriate to focus first on what we do know, and that concerns conditions necessary to promote investment.<sup>9</sup>

**Markets.** Investments can only be made where there is a market for the products or services produced by the investment at prices that cover its costs and promise a reasonable profit. Without markets there should be no investment – and when investment occurs where there are no markets, it often signals the existence of some form of market distortion. These markets can be local, national or international. One of the major limitations of investment in certain public services, such as water supply and sanitation, is the inability of local markets to support the costs associated with making and upgrading those investments. Understanding markets and ensuring that they function in a satisfactory manner is important to promoting investment flows.

**Labour.** The availability of (skilled) labour is frequently critical for investment. The appropriate framing of this issue is one of the more challenging tasks of the sustainable development debate. On the one hand, low labour costs are a critical source of comparative advantage for producers in developing countries; on the other hand, it is important that fundamental labour rights are respected. Where skilled labour is not available locally, the ability to move qualified persons in and out of the host country becomes important, in addition to the need to control certain key appointments in relation to investments that are integrated into an international product chain.

**Natural resources.** Numerous foreign investments are made to ensure access to important natural resources. Indeed, certain resources are so critical that investments are made almost irrespective of conditions in the host country. Some investors have struggled with issues relating to sustainable development of natural resources and other issues such as respect for the rights of indigenous populations.<sup>10</sup>

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

**Public institutions.** Foreign investors are dependent on the institutions of governance of the host country. They need timely, impartial and effective administration of the rules and regulations governing their activities, including reviews and appeals. While the existence of good governance alone does not guarantee the flow of investments, all other things being equal, the quality of governance can have a decisive impact on investment decisions.

**Private institutions.** Investments do not exist in an institutional vacuum: they require a range of private institutions to provide necessary support, mostly in the form of services: banking, legal advice and insurance at a minimum and, often, technical support and other forms of consulting services. Investment risk rises rapidly in the absence of such institutions.

Not all of these conditions are controlled by public authorities in the host country. For this reason, as for many others, successful investment policies require an unprecedented level of public–private co-operation as well as the active engagement of public authorities in different countries and the existence of appropriate international organisations. Promoting national and international mechanisms to foster these conditions must be the ultimate objective of international investment agreements.

Investment can occur in the absence of one, and sometimes even of all, of the above conditions, but it is unlikely to do much to promote sustainable development. Investment in the extraction of natural resources may be determined by a single consideration, namely where the needed resources are located. All other considerations recede next to this self-evident requirement. Yet, in the absence of some of the above conditions, international investment in natural resource extraction is unlikely to contribute to the sustainable development of the host country, let alone the host jurisdiction within that country. Numerous examples of oil extraction in particular can be cited to illustrate this point.

This list also illustrates that investment is a complex phenomenon with significant implications for sustainable development. An adequate understanding of the full agenda on investment is a condition for fashioning successful international investment regimes.<sup>11</sup>

## The pre-establishment phase

From the perspective of development, and of sustainable development in particular, the pre-establishment phase of productive long-term investment is critical. During this planning and preparation phase, key decisions are taken that determine the impact of an investment on a national economy, the environment and the community. Prospective investors articulate their goals and their activities. Depending on the size and nature of the investment, they require permissions and authorisations that can include the registration of a company (with the attendant rights and obligations, in particular in terms of hiring and taxes); permission to use certain public infrastructure such as roads and ports; and land use permits and environmental permits to use and discharge water, to emit wastes to the atmosphere or to otherwise manage the waste stream. In the case of large productive investments, each of these activities can have long-term implications for the local community and the environment. Entire ecosystems may be transformed, particularly by investments based on natural resources, and the prospects of a community to grow and prosper may be determined.

During the pre-establishment phase, the relationships between a prospective investor, the host country and the home country are likely to be more intense and entail more important decisions than at any other time in the life-cycle of an investment. In practice, a foreign investor is about to become an economic citizen of the host country. Just as countries have the right to accept or reject natural persons for citizenship, they need to be able to take considered decisions on the admission of economic citizens – because, once admitted, such citizens have rights that must be respected, not only because of international rules, but also on account of domestic legislation. In practice, this phase may entail a negotiation process and IIAs that create a right to invest – as some do – effectively shifting the balance between the investor and the host state in favour of the former, often eliminating controls a host state might use. In particular, applying the right to national treatment in a pre-establishment phase accords rights to foreign investors even though they

have not yet become economic citizens of the host state.

Some IIAs that include national treatment in the pre-establishment phase use lists to limit its applications. These can be positive lists that identify covered sectors, or negative lists with sectors that are excluded. The effectiveness of such lists in protecting the right of host states to pursue their development priorities depends on the quality of information concerning possible future implications of a listing, and on the ability to change sectors once they have been listed in or out. The availability of such information may vary widely, with governments of many developing countries at a pronounced disadvantage for lack of adequate information. These are matters that require negotiation in an environment where information is equally distributed. None of these issues can be determined on the basis of economic principles, so that adequate solutions require a careful balancing of sometimes conflicting priorities. In this respect, investment negotiations bear little resemblance to trade negotiations where an optimum economic outcome can be calculated, even if it cannot be attained in practice.

The admission of productive foreign investment to a country, like the approval of any productive investment, involves a complex process that is designed to ensure that all relevant interests are taken into account. These procedures range from the registration and governance of an enterprise to numerous licences that authorise the use of resources or public facilities, from environmental impact assessment to provisions for health and safety. They are accompanied by appropriate procedural requirements concerning the provision of information, transparency and public participation. And they are subject to administrative appeal and judicial review. An IIA that risks short-circuiting these requirements in any way would be harmful, undermining the essential development of the institutions required to support these procedures in an open society.

Once an investment has been made, relationships between the principal stakeholders shift notably. The investor has acquired important rights, not only in terms of permissions and authorisations but also broader rights based on the investment and the commitments it entails.

It is consequently important to distinguish clearly between the pre-establishment phase and the remaining lifetime of an investment, a lifetime that can run to many decades. It can even last more than a century, as is the case when virgin forest is converted to agricultural uses. The pre-establishment phase should be designed to ensure that a proper balance is struck between the legitimate interests of (private) investors and the public goods their investment is likely to affect. This is a demanding task that requires extensive administrative resources. In many countries, it includes obligations to inform the public and opportunities for public participation when the impacts of a proposed investment are expected to be extensive.

Following this initial determination of rights and obligations of key stakeholders in an investment, the focus shifts to ensuring that all parties live up to their commitments and that the balance that has been established is maintained in an appropriate manner. It is also critical that this balance be adjusted to new economic developments and to new knowledge or changes in policy priorities in a manner that reflects standards of good governance.

From the perspective of IIAs and development, one of the most important decisions concerns whether the agreement is to cover the pre-establishment phase, and if so, what kinds of disciplines are envisaged. A range of models exists in this regard, including agreements that establish binding limits on the host country's government action in the pre-establishment phase; agreements that enunciate general principles governing the pre-establishment phase; and agreements that do not address the pre-establishment phase at all.<sup>12</sup> None of the agreements to date addresses issues of investor responsibility or the role of home-country governments in the pre-establishment phase, a significant gap from a Southern perspective.

The implications of these arguments for a Southern agenda on investment are clear. The starting position for Southern negotiators is likely to be a rejection of pre-establishment commitments. Should there nevertheless be negotiations on such commitments, they need to be articulated in a manner that is notably different from the approach to be found in most existing IIAs, recognising that decisions on

the admission of investments can involve complex procedures in the host country, to which due deference must be given.

## **Re-thinking performance requirements**

'Performance requirements' are obligations imposed upon an investor by host state public authorities. They are typically part of the pre-establishment negotiations conducted between a prospective investor and the relevant home-state authorities, but they can also arise in connection with re-authorisation or the granting of some advantage to an existing investment. A wide range of performance requirements have been identified but they fall into six broad categories: export performance; joint venture and equity ownership; research and development; technology transfer; employment and training; and other requirements such as local content requirements or the provision of surety in the form of bonds or otherwise.<sup>13</sup>

Performance requirements make an investor give undertakings to meet certain criteria that would presumably not be met based on market criteria alone – otherwise there would be no substantive reason to impose them. Consequently performance requirements are widely seen as imposing an economic burden or otherwise decreasing the economic efficiency of an investment. Yet the literature on the appropriateness of performance requirements is ambiguous. Empirical economic analysis has shown that performance requirements can work, presumably because the loss of economic efficiency is more than outweighed by gains in development and public welfare.

Performance requirements are subject to a range of disciplines in some IIAs, while others do not address them. Most importantly, the WTO Agreement on Trade Related Investment Measures (TRIMs) effectively prohibits local content requirements; trade-balancing requirements; foreign exchange restrictions related to the foreign-exchange inflows attributable to an enterprise; and export controls. As with all WTO agreements, implementation of the TRIMs Agreement is multi-unilateral: each member state interprets it individually, subject to the possibility of a dispute being initiated to contest

its interpretation. The TRIMs Agreement, however, provides only state–state dispute settlement through the WTO Dispute Settlement Understanding. Such disputes are relatively unlikely, in particular with respect to individual investments, since states will need to weigh their interests in such a dispute against a general prudence in taking recourse to dispute settlement in the WTO. No investor–state recourse is available within the WTO.

A much longer list of performance requirements is prohibited, conditioned or discouraged by some bilateral investment treaties (BITs) or regional agreements such as the North American Free Trade Agreement (NAFTA). These include requirements concerning the establishment of joint ventures or domestic equity; the location of facilities; employment requirements; export requirements; restrictions on the sale of goods in the jurisdiction where production is located; supply of goods or services; sole-source supply agreements; technology transfer; and research and development. Other performance requirements, such as the obligation to provide surety, are not restricted.

It has been argued that developed countries used many of the policy tools in their development process that IIAs now seek to prohibit for developing countries.<sup>14</sup> Even if this was the case, it does not follow that developing countries will benefit from using the same tools under the dramatically changed circumstances of the early twenty-first century with decolonisation complete and the emergence of a global economy. Nevertheless, the obverse does not hold either – there are no adequate grounds to decide that performance requirements in general are unacceptable.

Just as pertinent is the fact that developed countries use complex rules of origin to establish trade preferences, many of which are by now sanctioned by bilateral or regional trade agreements. These have the same economic effect as performance requirements. Rules of origin require that products must contain a specified percentage of locally produced content to receive the preferred tariff treatments set out in bilateral or regional free trade agreements. Rather than specify export performance, rules of origin limit imports. They act as local content requirements. They also create power-

ful incentives to invest in the local jurisdiction in question or to establish backwards linkages to other local economic actors. Seeking to achieve these effects through direct policy measures is, however, just what performance requirement prohibitions seek to proscribe.

Performance requirements impact on many of the development priorities a government may be pursuing when negotiating with an investor. They can help to stabilise a relationship that is, by its nature, subject to a wide range of disturbances that can emanate from any of the parties to the process. Consequently, many developing countries consider the right to use performance requirements to be of vital importance in ensuring that foreign investment contributes to their development priorities. At the very least, it appears questionable whether IIAs should prohibit such requirements since the determination of their appropriateness often depends on the specific circumstances of an investment rather than on general economic principles, and is consequently best left to the participants in that decision. Moreover, powerful market disciplines exist to establish boundary conditions for performance requirements: when host states overreach they lose investment.

This suggests that developing countries should not accept provisions in IIAs that limit their use of performance requirements, or should at least be exercising great caution in doing so.

## **Host-state rights and obligations**

Most IIAs focus on investor rights and host-state obligations. The lack of consideration given to investor obligations has often been remarked upon. Yet there is also no visible effort to balance rights and obligations of host states, even though IIAs impact on both.

The most important of host-state rights – the right to regulate – is not in the gift of any investment agreement. It is an inherent element of the sovereignty of states. Indeed, regulation is a core function of a sovereign state, one that is untouched by debates concerning the appropriate form and degree of regulation that have raged in many developed countries for several decades. The right to reg-

ulate is so fundamental that it would be inappropriate for IIAs to address it as an exception to their own requirements.

It may be argued that the right to regulate does not need to be mentioned in IIAs. Yet IIAs impact on a host state's right to regulate, and it is imperative that these impacts be explicitly recognised and weighed and that drafters ensure that any limits imposed on this right are justified by commensurate benefits. That has not happened, leaving a situation where creeping limits are imposed on host states, often through dispute settlement procedures that themselves do not meet even the most elementary criteria of good governance.<sup>15</sup>

This stark statement of the current situation leaves an urgent need to ensure that limits placed directly or indirectly on the ability of host states to exercise their right to regulate are explicitly identified, precisely defined so as to limit the discretion of dispute panels, and fully justified.

Host-state's rights and obligations towards an investor, domestic or foreign, are in practice very extensive. The host state must adopt the full range of regulations that are designed to ensure that investors are accountable, that the impact of an investment on communities and the environment is acceptable, and that an investment contributes to public welfare through employment, taxes and in other ways. In practice, this involves the entire range of laws and regulations governing the conduct of business in the host country. At the same time, the host state must act in a manner that is legitimate, transparent and accountable and must protect the rights that investors and investments have acquired by virtue of investing in and conducting a business.

Most countries have elaborate legal and institutional arrangements to ensure a balance between investor rights and public welfare. All of these are potentially affected by IIAs as long as no provision is made to ensure that they are given due deference. These arrangements are robust, they continue to evolve, and they have withstood the test of time in developed countries. The situation in developing countries is different. Many developing countries have an incomplete institutional infrastructure to achieve the desirable balance. They seek to aug-

ment that infrastructure even as they seek to attract investors, both domestic and foreign, and many of the existing institutions have a limited history of dealing with major challenges. Developing countries that were previously colonised emerged from the colonial era almost devoid of indigenous institutions and of the human resources required to run, let alone to develop them. Lack of human and financial capacity continues to limit necessary institutional development in many cases.

It would seem almost self-evident that IIAs should contribute to the process of institutional development in developing countries. At the very least, they should not undermine it. Yet there is little in most existing IIAs that contributes to this goal. The approach of pre-emption that characterises many IIAs, that is the tendency to move disputes directly to the international level without providing for settlement in the host country, and without an expression of deference to the laws or institutions of the host country, may undermine efforts to achieve good governance domestically.

The unmet challenge is to devise international agreements that actually promote host-country institutional development. Presumably, this will require the elaboration of benchmarks that identify the degree to which host country institutional development meets international standards, and to link these to the specific provisions of the agreement itself. Countries that have adequate domestic institutions should largely be shielded from international interference. The goal here is not to create perfect institutions, but institutions that meet essential standards of good governance and that lead to results that appropriately reflect the interests of those who are affected by an investment. Countries that do not meet such standards should receive institutional assistance from the international level in a form that meets the same standards of process and outcome.

There is an astonishing degree of variation in the formulations that are to be found in existing IIAs, even among agreements signed by a single nation and even when expressing widely recognised principles such as national treatment, most-favoured-nation treatment, expropriation and minimum standards of treatment. This transfers the task

of determining whether such differences are meaningful to dispute settlement, and creates indeterminate scope for interpretation. It is likely that these variations do not reflect considered decisions, but are the result of indifferent negotiation of IIAs and a lack of public discussion of their purposes and how best to achieve them.

In addition, most IIAs fail to provide those responsible for dispute settlement with a reliable guide to negotiators' intent or with a framework for interpretation. By enunciating principles for non-discrimination and fair treatment of investors, but none for many other relevant dimensions of the investment process mentioned above, IIAs indicate that investor rights should be interpreted without reference to other priorities of development, let alone sustainable development.

It is important to ensure that the texts of investment agreements draw on a carefully developed vocabulary that can only be the result of extensive public analysis and debate. In practice, it is likely to require much more elaborate detailing of the intent and reach of rights and obligations that are created.

## **Investor rights and obligations**

The focus of many IIAs is on investor rights; mention of investor obligations is rare. Yet an investment agreement that does not address investor obligations is manifestly incomplete.

Investor obligations are qualitatively different than host-state rights or obligations or investor rights. An international agreement between sovereign states that seeks to create specific investor obligations is in many ways problematic. International agreements are concluded between – and impose obligations on – states. Normally, they impose obligations on individuals only by obligating states to take all necessary measures to ensure that their citizens act in accordance with international agreements. Some international agreements, in particular those dealing with human rights, create rights for individuals and are moving to create direct obligations as well. Yet in the absence of enforcement by states, the enforcement of these rights through international institutions is exceedingly difficult.

By contrast, IIAs that create rights for investors move in an environment with few precedents. They have succeeded by subjecting the conduct of states to investor–state arbitration. They do not, however, take the next step and seek to create obligations for foreign investors.

A canon of investor rights has emerged from existing IIAs. They include a parallel to the non-discrimination approach that has served the trade regime well, that is 'national treatment', 'most-favoured-nation treatment', and dispute settlement. This approach, however, fails to adequately recognise the differences between the relatively straightforward trade context and the web of relationships created by an investment to the host community and to multiple levels of government. As a result, the emerging experience with the North American Free Trade Agreement (NAFTA) and with several bilateral treaty arbitrations where this approach has been put into practice has indicated that, seen through the prism of investor–state dispute settlement, none of these provisions is without problems.<sup>16</sup>

Other key investor rights have also not been without problems. The most critical of these have been the right to a minimum standard of treatment by host states and protection against expropriation without compensation. The former is emerging, at least under some arbitrations, as an international law standard of transparency and good governance that is being imposed on host states without any sense that this was the original intention based on the history of the provisions in this area. The latter has now been expanded to include claims to compensation for regulatory measures that impact the economic performance of an investment. This issue is returned to more specifically below.

To a significant degree these problems are attributable to lax drafting practices that many assumed were appropriate for agreements between states, with the implicit safeguard of sovereignty in the implementation process. No such safeguards exist, however, in the investor–state dispute settlement process and lack of precision in drafting can lead directly to undesirable outcomes.

From a developing country perspective, what seems more critical than the idea of investor rights is

the ability to generate sufficient clarity in the scope of these rights so as to ensure both the investor and the host state have the capacity to function properly and without undue fear or burdens. That said, there is a significant question as to the ability of any national treatment obligation to operate without unduly restricting developing-country policy space to promote development linkages from foreign investments.

Efforts to generate obligations, or at least responsibilities, for foreign investors have been made in the past, but have never succeeded in the way the creation of investor rights have. One reason is that the affected individuals have made their views known unambiguously and have acted forcefully to avoid the drafting of open-ended rules.

Negotiations on binding investor obligations have been extremely contentious. More than 20 years ago, the United Nations Conference on Trade and Development (UNCTAD) attempted to undertake this task through its United Nations Centre for Transnational Corporations (UNCTNC). The attempt attracted the overwhelming resistance of major transnational corporations and of the governments of countries where they were domiciled, and it failed amid recriminations.<sup>17</sup> The UNCTNC was shut down, a rare occurrence in international organisations, and UNCTAD's work on international investment was stunted for many years.

The definition of less-than-binding investor obligations has had a less contentious history. The Organisation for Economic Cooperation and Development (OECD) elaborated *Guidelines for Multinational Corporations* that have been successfully amended.<sup>18</sup> A growing number of other voluntary guidelines have been developed and, recently, the International Organisation for Standardisation (ISO) has begun to work towards the development of a standard in this area. None of these statements of investor obligations have been linked successfully to any international investment agreements.

Since the demise of UNCTNC, there have not been any attempts to develop an approach to investor obligations that takes the needs and priorities of host countries as their explicit point of departure. In practice, the challenge involves striking a

proper balance between binding and voluntary elements in such provisions. Binding obligations can provide minimum-level protections for host states for such things as environmental assessments, human rights practices of foreign investors, anti-corruption requirements, and perhaps other minimal standards increasingly seen as critical from a sustainable development perspective. Voluntary elements can ensure that standards reflect actual business conditions and can evolve as what is generally accepted as good practice evolves.

None of the existing IIAs goes the obvious next step, namely to subject the conduct of investors to the rules and disciplines of dispute settlement. This goal can be achieved by making the obligations included in an IIA subject to domestic law and hence enforceable in domestic courts; by permitting state–investor arbitration; or by conditioning the access of investors to investor–state arbitration on a review of investor performance in relation to investor obligations, which can indeed be voluntary so as to ensure that they are appropriate to the size and nature of an investment. These obligations should also be sufficiently flexible to adjust to the changing understanding of appropriate investor practices. Additional depth for investor responsibilities can also come from the use of voluntary systems of standard-setting that involve the interested parties.

A further approach may be to ensure that investor performance with regard to a voluntary standard can become part of any investor–state (or state–investor) dispute settlement process. Investors may be given a choice of voluntary codes to adhere to and may be required to identify a code that they accept and the process by which their practices are being monitored, including the option of audits that report to corporate boards.

This is a debate that has not been pursued, leaving significant ambiguity concerning the expectations of host developing countries with respect to investor behaviour. Addressing this side of the investor–host state relationship for inclusion in IIAs has been raised expressly by developing countries such as China, India and Brazil, and is an increasingly prominent issue for civil society.

## Home-state rights and obligations

Existing IIAs do not address home-state rights and obligations. Yet home states are indubitably stakeholders when it comes to foreign direct investment. The interests of home states are largely determined by their desire to ensure the security of their investors, who will in many instances be exporting capital from the home state and repatriating profits.

The rights of home states revolve around measures they may adopt to promote foreign investment and to help their investors manage the attendant risks, which are typically related to the movement of capital and the security of investments in the host state. This can involve investment promotion and various forms of insurance. While these can serve the interests of all parties – home state, host state and investor – it is essential that they be handled in a manner that is rules-based and transparent, a task that IIAs can help to accomplish.

The obligations of home states are more difficult to define. Home states may be expected to provide certain information, assist in combating corruption, and ensure that investor liability extends to the home state in an appropriate manner. An emerging problem is the use of ‘home states of convenience’ by investors who have no substantial activity in those states, with the potential to undermine the effectiveness of IIAs in much the way that flags of convenience render the control of shipping practices particularly difficult. Each of these areas presents challenges in terms of drafting and implementing IIAs that promote development in host states.

The problem of ‘home states of convenience’ can be resolved by making the designation of a home state a matter of mutual agreement between investor and host state, subject to certain principles that establish that an investor must have a material relationship to a designated home state. Such an approach can be decoupled from the legal, financial and tax considerations that frequently determine the place of incorporation for certain investments. This approach permits the development of more substantive provisions concerning home-state obligations.

Once it has been established that the investor has a material relationship with the home state it

also becomes possible to draw on relevant information that may be available to home-state authorities concerning the investor and his or her operations. This is not a simple matter, since much relevant information is dispersed among home-state agencies and it is imperative to ensure that confidentiality is maintained throughout. Nevertheless, the home state may be able to provide important assistance to host states confronted with complex, technically demanding investments and lacking many resources that may be required to deal with them appropriately.

The problems of corruption are widely recognised. Yet combating corruption that involves international investment is particularly challenging since it requires commitment and effort on the part of all actors, investors, home states and host states. Home states may be needed to ensure, in particular, that investors publish information on payments they make to public authorities or their agents in host countries, and to make corruption by investors a criminal activity at home, even for acts taking place abroad.

Finally, home states have a role to play when their investors incur liability in the host states through actions that originated in the home state, or when those who are liable are out of reach of host-state authorities without assistance from home states.

It is striking to note that from the perspective of sustainable development, home states have a much more active and important role than is generally recognised by IIAs, or even discussed in the literature. The simple conclusion from the perspective of a Southern agenda is that many host states cannot respond appropriately to investment opportunities without the help of home states.

## Dispute settlement

Dispute settlement is a key institution for the implementation of trade agreements, ensuring that the unilateral interpretation of the multilateral rules by each party is subject to review – and possible dispute – by all others. Dispute settlement in trade law is an exclusively state–state process.

Investment agreements are implemented in an entirely different manner. The primary, though not

the only, relationship for implementation is between the host state and the investor; hence state–state dispute settlement is unlikely to play a major role in the implementation of IIAs. This has led to the introduction of the investor–state dispute settlement process in IIAs.

International dispute settlement was originally designed to resolve specific instances of conflict between states and between private parties. It was not designed for disputes between private parties and states that require much more elaborate procedural safeguards to protect the rights of both parties. It was not designed to create a body of interpretation that could shift the balance of rights and obligations of parties to an agreement or of those affected by it. The absence of *stare decisis*, that is the assumption that no dispute would prejudice the handling of other disputes, was an essential tool in limiting the functions of dispute settlement. Absent *stare decisis*, there was also no need to establish an independent international judiciary, to ensure that decisions were publicly available, or to foster a culture of analysis and discussion to ensure that mistakes could be identified and ultimately corrected. Yet investment dispute settlement has now embarked on a course that effectively assigns dispute panels an active role in implementation and interpretation without any of the institutions of good governance that are essential to such an undertaking in other jurisdictions.

For many years, there were not many investor–state disputes (or at least few became known, since there was, and is, no publicly available source to monitor all such disputes). Investor–state dispute settlement did not attract much attention, but then neither did IIAs. Problems with investor–state dispute settlement have only emerged since investment agreements became a contentious issue about 10 years ago. These problems concern less the principle of investor–state disputes – which reflects the problem structure of IIAs in a compelling manner – than the appropriateness of the institutions involved and whether the text of IIAs provide sufficient guidance to the dispute settlement process to ensure that it does not lead to unacceptable results. By now the number and seriousness of the concerns about investor–state dispute settlement are so sig-

nificant that they fester like an open wound. Fortunately, there are solutions to most of these concerns. Central to any Southern agenda on investment is a requirement to ensure that the approach to dispute settlement is fully revisited.

There is no compelling reason why review of an investor's claims against a state cannot be undertaken by the institutions of the state in question – provided these are independent of the public authority that is in dispute and discharge their duties in accordance with basic principles of good governance, including an independent judiciary. This is the approach outlined in GATS Article VI on domestic regulation of services. International investor–state dispute settlement is only needed when this process fails and an investor suffers serious damage without adequate recourse.

Unfortunately, there is little indication in the texts of IIAs that negotiators have acted with prudence to promote better domestic dispute settlement in the host state or to ensure that international processes respect basic principles of good governance. The result has been that the vagaries of investor–state dispute settlement have become such that prudent administrators may now avoid the most legitimate of actions to minimise the chances of being caught up in such a dispute, a phenomenon known as regulatory chill. This highly undesirable outcome is the result of IIAs that have only addressed a limited part of the agenda associated with international investment and that are inadequately drafted; and of shortcomings of dispute settlement institutions. No agreement that fails to confront these problems comprehensively can be expected to address the needs of developing countries.

The shortcomings in drafting described earlier in relation to the articulation of investor rights are compounded by the inadequacies of the arrangements for dispute settlement. Existing dispute settlement institutions were not designed to address the complex issues of public policy that now routinely come into play in investor–state disputes. They were created at a time when there was little international investment, few international investment agreements and scant discussion of what the appropriate rules for a globalised economy might look

like. Indeed, the concept of globalisation itself had not yet been articulated. It is, consequently, hardly surprising that the investor–state dispute settlement process is characterised by a lack of transparency and suffers from structural conflicts of interest. In response to criticism, some modest changes have occurred in some of the available dispute-settlement institutions. Disputes filed with the International Centre for the Settlement of Investment Disputes (ICSID), which is closely linked to the World Bank, are now listed on a publicly available register. An arbitral panel (operating under rules of the United Nations Commission on International Trade Law, UNCITRAL) has accepted *amicus curiae* briefs. And arguments in some cases have been made in public. This is at best a beginning.

Solutions to the issues of dispute settlement are available. They include more transparency; selection of arbitrators in a neutral manner rather than by the parties; proper deference to domestic dispute-settlement procedures; clear separation of the functions of arbitrator and advocate; and the introduction of an appellate process. Most of these changes by now appear inescapable. The precise manner in which these steps are taken must be the outcome of analysis, debate and proper negotiations, in which developing countries participate.

These issues far transcend the needs of a Southern agenda on investment, reflecting matters that should be of concern to all governments. Yet developing country host states are more affected by them than any other actors in the investment process by the simple fact of the number of arbitration claims they face, and will continue to face into the future. While these problems need to be addressed in the interests of everybody concerned with governance of the global economy, they are of overriding concern for developing countries.

## Monitoring results

It is important to identify the anticipated results of any international agreement that deals with investment. Otherwise there is no standard against which to assess its effectiveness. And it is necessary to monitor actual outcomes in light of projected results.

Economic theory indicates that liberalisation of trade will generate benefits almost automatically, although it says nothing about the distribution of these benefits. No similar conclusions apply to either the liberalisation of investment or the introduction of new rules to promote investment or to ensure adequate international governance of investment. Indeed, most existing investment agreements are characterised by a substantial degree of uncertainty concerning their practical consequences. It is, consequently, essential to monitor international investments and the impact of IIAs to ensure that lessons can be learned from experience in a timely manner and to identify further steps that can be taken to improve effectiveness. It is striking that the single most important factor among the many economic drivers of globalisation – investment – has no single international institutional focal point.

Most current information on international investment is quantitative. International investment flows and stocks have been assessed regularly for many years.<sup>19</sup> Yet qualitative information is exceedingly hard to come by, in particular qualitative information that is systematic and covers most countries. Indeed, there is not even much agreement on the criteria to apply in gathering such information. The place to start is the articulation of widely accepted, carefully negotiated purposes for international investment agreements.

Monitoring the results of investment agreements requires an institutional and organisational framework that is capable of undertaking such a task – and that is subject to the same principles of governance as investment, that is it is legitimate, transparent and accountable. In practice this implies robust institutional means and an organisational structure that reflects the needs of all actors in international investment. While it is possible to identify some of the necessary elements of such an institutional framework for international investment – and existing international organisations such as the United Nations Conference on Trade and Development and the World Bank provide some elements – its final shape must be the product of careful negotiation.

## **Institutions and funding for investment agreements**

It is difficult to overstate the uncertainties associated with governance for international investment, in particular when the primary focus is the development of a Southern agenda. All governance concerning investment must originate at the national level. Hence the first priority is to find ways to strengthen national investment governance.

The relationships among investment actors at the international level are poorly developed. These relationships need to be explored over time and the appropriate institutional responses must be identified. The ultimate goal is a robust, legitimate, transparent and accountable system of international governance for investment that takes full account of the development priorities of developing countries. This can only be the result of a process that extends over a period of years and is constructed to permit learning and adjustment as greater understanding of the specific requirements is developed. The principal task of an international agreement on investment that reflects the needs of sustainable development is consequently to articulate the general principles that are to apply, to put in place an initial set of measures, and to establish procedures that permit the dynamic adjustment of the regime over time.

IAs are constructed like trade agreements on the assumption that they are largely self-executing and that their benefits are automatic. Yet investment promotion, a frequently articulated goal of IAs, let alone the promotion of sustainable investments, requires a greater degree of institutional capacity, and must be supported by funding.

Investment involves case-by-case decisions for investors as well as public authorities. While some investments occur in accordance with well-established practices and consequently require little or no discretionary action, other investments engender long and complex decision-making processes for investor and host state. The institutional capabilities of both parties – and the ability to take into consideration additional concerns of other stakeholders – are of critical importance. While most of these institutions will be domestically based, some may involve other countries in regional co-operation,

and some may engage international organisations in a variety of ways, including the World Bank and the International Finance Corporation (IFC). IAs must contribute to institutional development and the proper functioning of these processes, and not only by means of dispute settlement when one party believes they have gone wrong.

The institutional needs for this purpose at the international level are not all currently known. Some have been developed by the World Bank Group but now need to better reflect the interests of all countries concerned than the governance structure of the World Bank will ever permit. Some can be derived from existing models, in particular in the areas of trade policy and international environmental management. Some will need to be developed step by step as needs are recognised and institutions are fitted to these needs. The implications for IAs are relatively clear: they must have the flexibility to respond to new institutional needs as they arise.

The broader question of funding in support of investment (in particular foreign investment) to countries that currently receive less than might be expected in light of their needs and the prevailing conditions, poses numerous dilemmas. Again, the World Bank Group has long played a role in this area, but the need to repay World Bank loans renders them less suited to institutional development and capacity building, since neither activity is liable to generate a revenue stream capable of amortising a loan. The ability of the International Finance Corporation (IFC) to participate in investments – and to hold equity stakes – represents one important avenue for improving the ability of least-developed countries to attract investment. Yet the crucial issues of institutional development and capacity building remain unresolved, in addition to the issues surrounding World Bank governance.

A robust international regime for investment needs to be able to generate funds to support institutional development, to undertake capacity building and to improve key factors that may influence investment decisions. These funds must be governed in an equitable manner by all the countries that participate in a particular regime, reflecting both the ability to provide capital and some criteria of need.<sup>20</sup>

## Conclusions

Existing IIAs have not been designed to meet the development needs of developing countries, let alone to promote sustainable development globally. To pursue these goals, future investment agreements will need to exhibit a number of critical characteristics:

- Recognise that an investment agreement is fundamentally about good governance to ensure that investor rights and public goods are protected in a manner that is legitimate, transparent and accountable.
- Apply basic standards of good governance to the international agreement itself.
- Establish a clear purpose or objective for the international agreement: to create an approach to international investment that respects the aspirations of developing countries and promotes global sustainable development.
- Contain clear provisions that balance investor rights with investor obligations, and with host and home-state rights and obligations.
- Set out specific proposals to fix what is currently a broken investor–state dispute settlement system.
- Include an approach to investor obligations that strikes a balance between voluntary and binding elements.
- Provide an institutional framework that ensures monitoring of its progress as an instrument of development, promoting learning from its errors and creating a foundation for future improvements.

Investment is central to any attempt to promote sustainable development. It is hard to conceive of a global economy without a robust, creative and transparent set of rules for investment. A bold new approach will set an agenda to improve the international investment climate and to advance sustainable development, giving greater certainty to investors faced with demands from many stakeholders and rewarding companies that already follow good practice.

## Endnotes

1. See United Nations Conference on Trade and Development (UNCTAD), World Investment Report (annual), UNCTAD, Geneva.
2. UNCTAD (2004) *Incentives*. UNCTAD Series on Issues in International Investment Agreements, UNCTAD, Geneva.
3. For details, see the SAI case studies on Argentina ([www.iisd.org/pdf/2004/investment\\_country\\_report\\_argentina.pdf](http://www.iisd.org/pdf/2004/investment_country_report_argentina.pdf)) and Brazil ([www.iisd.org/pdf/2004/investment\\_country\\_report\\_brazil.pdf](http://www.iisd.org/pdf/2004/investment_country_report_brazil.pdf)).
4. This generally includes bilateral investment treaties (BITs), bilateral, regional and inter-regional trade agreements that include investment provisions, and multilateral investment agreements. Agreements on trade in services include investment provisions as well.
5. Mary Hallward-Driemer, (2003) *Do Bilateral Investment Treaties Attract FDI? Only a bit ... and they could bite*, World Bank, June, [http://econ.worldbank.org/files/29143\\_wps3121.pdf](http://econ.worldbank.org/files/29143_wps3121.pdf). For an alternative view, see Jeswald Salacuse and Nicholas P. Sullivan (2005) 'Do BITs Really Work? An Evaluation of Bilateral Investment Treaties and Their Grand Bargain', *Harvard International Law Journal*, Vol. 46, No. 1 (Winter 2005), pp. 67–130. The focus of this paper is, however, on US BITs, including NAFTA and a US–China BIT so they are highly particular.
6. Luke Eric Peterson (2004) *Bilateral Investment Treaties and Development Policy-Making*, International Institute for Sustainable Development (IISD), Winnipeg, MB, p. 4: '– the author's experience of examining more than 150 [bilateral investment] treaties ... suggests that references to development are exceedingly rare in treaties pushed by a number of Western governments with developing countries'.
7. Salacuse, Hallward-Dreimer (see note 5).
8. See Luke Eric Peterson, *Bilateral Investment Treaties* (see note 6).
9. V.N. Balasubramanyam, 'Foreign Direct Investment in Developing Countries: Determinants and Impacts', paper prepared for OECD Global Forum on International Investment, Mexico City, Nov. 26–27, 2001, p.13.
10. See Mining, Minerals and Sustainable Development at [www.iied.org/mmsd/finalreport](http://www.iied.org/mmsd/finalreport).
11. United Nations Economic Commission for Latin America and the Caribbean (ECLAC), Preliminary Version of the Foreign Investment in Latin America and the Caribbean 2005, ECLAC, Santiago., Maurice W. Schiff and L. Alan Winters (2003), *Regional Integration and Development*, Oxford University Press, New York. See also the *World Bank Investment Climate Surveys* at <http://rru.worldbank.org/InvestmentClimate/>
12. The WTO General Agreement on Trade in Services (GATS) establishes most-favoured-nation treatment in Article 2 as a general obligation, subject to possible negative listing. It also includes a range of pre-establishment provisions that apply when a country has made commitments on specific sectors and specific modes of supply of services. As a rule, the country will have opened its market to service suppliers in the committed areas on a national treatment basis.
13. UNCTAD (2003) *Foreign Direct Investment and Performance Requirements: New Evidence from Selected Countries*, UNCTAD, Geneva.
14. Ha-Joon Chang, *Kicking Away the Ladder. Development Strategy in Historical Perspective*, Anthem Press, London.
15. Aaron Cosbey, et al., (2004) *International Investment and Sustainable Development: A Guide to the Use and Potential of International Investment Agreements*, IISD, Winnipeg, MB.

- [www.iisd.org/publications/publication.asp?pno=627](http://www.iisd.org/publications/publication.asp?pno=627).
16. Howard Mann (2001) *Private Rights, Public Problems. A Guide to the NAFTA's Controversial Chapter on Investor Rights*, IISD, Winnipeg, MB. [www.iisd.org/publications/publication.asp?pno=270](http://www.iisd.org/publications/publication.asp?pno=270).
  17. UNCTNC, 'Draft United Nations Code of Conduct on Transnational Corporations,' in UNCTAD, *International Investment Agreements. A Compendium*, Vol. 1: Multilateral Instruments, United Nations, New York.
  18. OECD (2000) *OECD Guidelines for Multinational Enterprises: Text, Commentaries and Clarifications*, OECD, Paris. [www.oecd.org/olis/2000doc.nsf/LinkTo/daffe-ime\(2000\)20](http://www.oecd.org/olis/2000doc.nsf/LinkTo/daffe-ime(2000)20)
  19. Annual reports on investment are published by UNCTAD and by some of the UN regional commissions.
  20. The governance structure of the Global Environment Facility, which requires double majorities for formal decisions, may offer useful lessons.