



Trade Hot Topics

Emerging Investment Rules in Mega Trading Blocs: Implications for Developing Countries

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Foreign direct investment (FDI) can serve as a potent tool for economic development and poverty reduction – through employment generation, knowledge and technology transfer, diversification and value addition. In 2012, the global stock of FDI was around US\$22 trillion and global sales from foreign invested companies were US\$28 trillion as against the world GDP of US\$70 trillion.¹ In the same year, global exports in goods and services were US\$22 trillion and multinational corporations driving global value chains account for about 80 per cent of it. As regards job creation, according to UNCTAD World Investment Report, 21 million people were employed by foreign invested companies in 1990 while this number rose to 69 million in 2011. The rising value and associated benefits of FDI make it a very valuable source of the much needed capital and knowledge for developing countries.

However, the changing global trade architecture as manifested in emerging mega-regionals are likely to have serious implications for FDI flows. In this respect, two of these mega-regionals, namely the Transatlantic Trade and Investment Partnership (TTIP) and Trans-Pacific Partnership (TPP), can exert the most profound impact. Each of these arrangements affects at least a quarter of world

trade in goods and together they account for more than half of global FDI flows. They contain major hubs in global value chains, having a significant share in trade in intermediate goods and services in the region. From an investment perspective, the relevance of these arrangements stems from firstly, the volume of FDI associated with these arrangements (Table 1). Secondly, member countries of TTIP and TPP, in particular the European Union (EU), the USA and Japan, still account for more than half of the global FDI outflows. Given the economically dominant positions of these countries, any trade and investment agreement between these countries will inevitably impact all facets of global economic governance. Thirdly, unlike bilateral investment treaties (BITs) TTIP and TPP are free trade agreements (FTAs) having a comprehensive scope, and will require harmonisation and a common approach in several legal and policy areas impacting investment. Finally, these mega trading blocs are also bringing in new standards in trade in goods and services. FDI flows associated with these goods and services will therefore be affected.

This issue of *Commonwealth Trade Hot Topics* examines some aspects of investment provisions

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¹ Hufbauer, G and Peter, D (2013), 'Facts and Figures', Foreign Direct Investment as a Key Driver for Trade, Growth and Prosperity: The Case for a Multilateral Agreement on Investment, World Economic Forum, Geneva, 2013.

Table 1: FDI Inflows to Selected Regional and Inter-regional Groupings, average 2005-2007, 2008-2013 (US\$ billion)

Regional/Inter regional groups	2005-2007 Average	2008	2009	2010	2011	2012	2013
G20	879	992	629	740	887	712	789
APEC	559	809	486	656	781	699	757
TTIP	834	852	502	573	700	375	444
TPP	362	523	276	379	466	404	413
RCEP	195	293	227	284	350	329	326
BRICS	158	284	201	237	286	267	322
NAFTA	279	396	183	249	290	226	260
ASEAN	64	51	48	98	110	113	116
MERCOSUR	31	59	30	61	85	85	83
Memorandum: percentage share in world FDI flows							
G20	59	55	52	52	52	54	54
APEC	37	44	40	46	46	53	52
TTIP	56	47	41	41	41	28	30
TPP	24	29	23	27	28	31	28
RCEP	13	16	19	20	21	25	22
BRICS	11	16	16	17	17	20	22
NAFTA	19	22	15	18	17	17	18
ASEAN	4	3	4	7	7	9	8
MERCOSUR	2	3	2	4	5	6	6

Note: Ranked in a descending order of the 2013 FDI flows.

G20 = 19 individual member economies of the G20, excluding the European Union, which is the 20th member, APEC = Asia-Pacific Economic Cooperation, TTIP – Transatlantic Trade and Investment Partnership, TPP = Trans-Pacific Partnership, RCEP = Regional Comprehensive Economic Partnership, BRICS = Brazil, Russian Federation, India, China and South Africa, NAFTA = North American Free Trade Agreement, ASEAN = Association of Southeast Asian Nations, MERCOSUR – Common Market of the South.

Source: UNCTAD

being considered as part of Trans-Atlantic and Trans-Pacific mega-regionals, and their likely implications for excluded developing countries.

Investment rules in mega agreements

Various drafts have either been released by governments or by other sources. These drafts, publicly stated negotiating objectives and recent agreements signed by the member countries ('reviewed drafts') provide some guidance on the likely content of these mega-agreements.² A

review of these drafts indicates that the following may be some of the legal provisions that are likely to be included:

- Wide asset based definition of investment that includes the categories of tangible and intangible property.
- Though the national treatment (NT) and most favoured nation (MFN) standards will likely be included, the true scope of their application can be assessed only after considering the list of

² Agreements reviewed are US Model Investment Treaty, 2012, TPP's leaked investment text, EU's leaked TTIP investment chapter, ASEAN Comprehensive Investment Agreement, 2009, Australia-Chile Free Trade Agreement, 2008, Trilateral Agreement between China, Japan and South Korea, 2012, EU-Canada FTA.

non-conforming measures. There is currently no information available on the possible content of the annexes on non-conforming measures in the agreements. Based on the reviewed drafts, government procurement and subsidies/grants may be excluded from the application of both the standards.

- Prohibition on performance requirements, which are mandatory conditions that investors need to perform, either as a precondition to entry into a country or to receive specific incentives. In particular, requirements relating to mandatory exports, mandatory level of domestic content, supply to a specific region, and preference to technology of local parties. The reviewed drafts also indicate that some exceptions may be carved out – for example for compulsory licence granted in accordance with TRIPS Agreement or for adoption of measures to conserve natural resources, protect human, animal or plant life, or for government procurement.
- Protection from direct and indirect expropriation. Much of the criticism of investor-state dispute settlement (ISDS) has been around the enforcement of provisions like this. Indirect expropriation has been interpreted by arbitral tribunals quite widely, to include measures such as cancellation of concessions, licences or permits, changes of regulations, if such measures result in total deprivation of investor's property, forceful changes to contracts, and tax related confiscations. To provide interpretational guidance, newer investment treaties (including many of the reviewed agreements) have explicitly started providing criteria to make a determination of indirect expropriation. The reviewed drafts indicate that criteria that may be included are economic impact and characteristics of the measure imposed, the level of interference with investment backed expectations of the investor and duration of the measure or its effects. Further, to preserve the right to regulate,³ states are now explicitly carving out a specific exception stating that not all measures taken by the state can be challenged and found expropriatory.⁴ Recent investment treaties, including many of the

reviewed drafts, have also been carving out an exception to (i) address environment, health and public concerns, or (ii) implement compulsory licences issued by World Trade Organization (WTO) members in accordance with WTO agreements. Such exceptions may find a place in the mega agreements.

- Guarantee to allow investors to transfer funds into and outside the host state. Almost all reviewed drafts provide this guarantee for the purpose of *inter alia* capital contribution, repatriation of profits, dividends, capital gains, and proceeds from the sale, liquidation of investment, payment of interest, royalty, management fees, payment arising out of a dispute or under a contract. The reviewed drafts specify that transfer should be allowed in freely usable currency and at the market rate of exchange at the time of the transfer. The likely inclusion of this provision in the TTIP and TPP agreements has met with criticism on the ground that it curbs states' ability to maintain capital controls and goes beyond even what is prescribed by the International Monetary Fund (IMF). The IMF draws a distinction between capital and current account transactions and requires member states to guarantee free movement only for the latter (i.e. current account transactions).

To create regulatory space for the state, new investment treaties, including the reviewed drafts, have started providing certain exceptions to this guarantee. Generally, these exceptions fall into two categories – (i) restrictions imposed by states due to good faith, non-discriminatory application of laws relating to bankruptcy, securities, futures, criminal offences, financial reporting, and taxation, and (ii) restrictions imposed by states in macroeconomic circumstances such as when balance of payments may be affected.

- The fair and equitable treatment (FET) standard requires governments to act in a fair, just and predictable manner and was included in all the reviewed drafts. It is also the most frequently invoked clause in investment arbitration. Article

³ See Spears, S (2010), 'The Question for Policy Space in a New Generation of International Investment Agreements', *Journal of International Economic Law*, Vol. 13, Issue 4, p. 1037; and OECD Directorate for Financial and Enterprise Affairs (2004), 'Indirect Expropriation and the Right to Regulate in International Investment Law', OECD Working Papers on International Investment No. 2004/4, p. 22.

⁴ For example, Annex 12C of the TPP text provides that, 'Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect the legitimate public welfare objectives, such as public health, safety and the environment, do not constitute indirect expropriations.'

12.6 of the TPP leaked text seeks to provide some interpretative guidance, by stipulating that treatment of aliens should be as per customary international law (i.e. results from general and consistent practice of states that they follow from a sense of legal obligations) under the FET provision. It further clarifies that FET does not require treatment in addition to that standard or create any additional substantive rights. However, it must be kept in view that 'customary international law' is in itself expansive. Though investment treaties do not provide much guidance on the meaning of FET standard, a review of arbitration cases indicates that it has been interpreted to mean: (i) stability and predictability in the legal and business environment, (ii) protection of legitimate expectations of investors, (iii) prohibition of denial of justice (including following due process), (iv) transparency (i.e. investors should be aware of the rules applying to them), and (v) proportionality between the measure imposed and objective sought. Such interpretations have a wide sweep and can potentially impact government's legitimate regulatory functions. Since FET is an absolute standard of treatment, it is detached from the host country's own domestic laws and regulations. The EU's TTIP leaked text provides more explicit and specific guidance on FET standard and stipulates that government measures should not lead to:

- a. Denial of justice in criminal, civil or administrative proceedings; or
- b. Disregard of the fundamental principles of due process; or
- c. Manifest arbitrariness; or
- d. Targeted discrimination on manifestly wrongful grounds, such as gender, race or religious belief; or
- e. Abusive treatment of investors, including coercion, duress and harassment; or
- f. A breach of legitimate expectations of investors arising from a government's specific representations or investment-inducing measures; or

g. A disregard of the principle of effective transparency in any applicable administrative or judicial procedures.'

The EU-Canada FTA also defines the FET standard in a similar manner. In addition, it clarifies that breach of legitimate expectations is limited to situations where the investment took place only because of a promise made by the state that was subsequently not honoured. Both the TPP leaked text and EU's TTIP leaked text also clarify that a violation of any other term of the agreement will not establish a breach of FET. These drafts suggest that TTIP/TPP member countries are increasingly recognising the need to limit the interpretational flexibility associated with the FET standard.

- Though not currently included in many of the reviewed drafts, transparency obligations have been found in recent US treaties and may find a place in the mega agreements. The provision requires that when any policy/regulatory changes are made, they must be published and reasonable consultations must be held with stakeholders. In addition it may require notification, if an investor is specifically impacted by a measure, fair process and a right of appeal to the affected investor.
- ISDS is one of the most controversial provisions of investment treaties.⁵ It allows investors of any signatory country to directly bring a law suit against another signatory country for alleged violation of the investment treaty. The process involves setting up of an arbitration tribunal outside the control of any government that then decides on the specific aspects of the case. Investors directly take their case to this panel rather than the courts of the host country. Though it depoliticises dispute resolution and allows enforcement of treaty provisions, there are legitimate concerns around ISDS. It is criticised for the expansive interpretation of treaty provisions by arbitral tribunals and issues around the ISDS process (e.g. transparency, and composition of panels). There is much uncertainty on whether ISDS will find its way into the mega agreements. During the TTIP negotiations, the general resistance of some

⁵ The major criticism against ISDS is that private (i.e. non-government) arbitrators, as opposed to domestic legal systems, are essentially becoming law-makers, determining the manner in which public-private relations should be governed. Since government conduct and private rights are governed not by democratically legitimised domestic courts, but by party-appointed arbitral tribunals not bound by a code of conduct similar to state judiciaries, questions about the legitimacy of ISDS have been raised. In addition, concerns are based on various other aspects of the ISDS process. For example, contrary to domestic courts, decisions of arbitral tribunals are final (cannot be appealed), and the costs of merely appearing in an ISDS case (irrespective of a decision) run into millions of dollars.

stakeholders against ISDS stemmed from the view that both the EU and the USA have long established legal traditions, independent judiciaries with years of experience and thus the ISDS process was not required as such. While the EU's TTIP leaked text does not include a specific provision on ISDS, it does provide a set of guidelines for the negotiation of the ISDS provision. The guidelines prescribe that ISDS should not apply to market access commitments and the process should encourage amicable settlement. Notably, the guidelines also state that the agreement should include provisions dealing with *manifestly unjustified claims*, allowing appeals on questions of law, and preventing excess compensation and multiple claims against a state. These guidelines reflect EU efforts to limit and clarify the scope of ISDS. The EU's cautious approach is also reflected in the EU-Canada FTA. All TPP member states are already parties to free trade agreements and bilateral investment treaties that include ISDS provisions.⁶ The TPP leaked text indicates that Australia intends excluding itself from TPP's binding ISDS mechanism. Australia's position on inclusion of ISDS in bilateral investment treaties has been changing and it appears that ISDS would be considered on a case by case basis.

- Though not found in all reviewed drafts, specific provisions on environment and corporate social responsibility (CSR) have been proposed by some parties to TPP. Article 12.15 allows the member countries to adopt, maintain or enforce any measures 'otherwise consistent with this chapter' to ensure that investment activity in its territory is undertaken in a manner sensitive to environment, health, safety and labour concerns, and member countries should not waive or derogate or offer to waive or derogate from health/safety/environment measures to attract and retain investment. The TPP text also includes a provision allowing members to encourage companies to voluntarily incorporate internationally recognised standards of CSR.

Implications for non-member developing countries

The mega agreements will likely liberalise some sectors for investment, provide NT and MFN standards for establishment and generally improve

investment conditions. This implies that some of the largest FDI home countries (such as the USA, Germany and Japan) will have improved access to markets of developing member countries. Other aspects such as absence of performance requirements will also reduce the cost of doing business. Increase in competitiveness of member developing countries in this manner will comparatively diminish the competitiveness of non-member developing countries as attractive FDI destinations. Though there is mixed evidence on the link between investment treaties and investment flows, it is known that companies – particularly those that are efficiency seeking and closely linked to global value chains – are sensitive to governance, legal and regulatory frameworks of potential host countries. Thus, where all other factors that determine attractiveness are similar in two countries, the quality of governance, legal and regulatory frameworks can distinguish one from the other.

As discussed earlier in this paper, any investment rules adopted by the member countries will impact global rules on investment. The challenge with some of the rules that are likely to be introduced (and discussed above) is that they are fairly difficult to implement for developing countries, given their institutional frameworks and resources. Mere adoption of new rules without implementation could in fact make developing countries more vulnerable to domestic as well as international disputes. An example of a valuable principle which requires high level of institutional capacity and co-ordination is transparency. Another example is prohibition on performance requirements – developing countries frequently use these tools to 'quickly' achieve specific policy objectives like increasing local employment or use of local raw materials, and technology transfer. Aligning domestic laws and policies with the new global rules on investment will require reconsideration of these performance requirements (some of which are already illegal under WTO's TRIMs agreement). On a positive side, this could also be viewed as an opportunity for non-member developing countries to reassess and upgrade their investment rules to increase investor confidence and minimise potential for discrimination and institutional inefficiencies, in a manner most suitable for their stage of development and capacity. The growing

⁶ Australia-Singapore investment treaty, Thailand-Chile investment treaty, ASEAN-Australia-New Zealand Free Trade Agreement; Japan under nearly all of its investment treaties and economic partnership agreements including with several TPP member states; and Canada, the USA and Mexico under the North American Free Trade Agreement.

importance of global value chains involving complex and interconnected cross-border flow (of goods, capital, people and knowledge) and increased linkage between trade and investment, makes innovative and deeper policy/law-making essential. The TTIP and TPP arrangements may just provide the thrust needed to drive developing countries to transform their policy/legal environment to better address these emerging economic realities.

It should also be kept in view that most proposed rules are not new.⁷ For example, Mozambique's investment treaty with the Netherlands and Luxembourg already includes a transparency provision, while the Dominican Republic-Netherlands treaty provides MFN and NT standards with respect to taxes, fees, charges and to fiscal deductions and exemptions. Some investment treaties signed by developing countries even go beyond what may be stipulated under the TTIP and TPP agreements. For example, the UK-Ghana investment treaty provides that compensation for expropriation should be paid within six months, after which interest will be charged until date of payment. The six months timeline can be quite a severe one for some developing countries, with slower processing times. In such situations, the new rules of TTIP and TPP will not add to the already existing obligations of the non-member developing countries.

If ISDS is included in the TTIP and/or TPP agreements, it will also provide the thrust for pushing ISDS as a prevalent model for investor protection. But it is clear that in its current form, areas of concern with ISDS will remain. What types of improvements will be brought in and to what extent those will address the points of criticism should be closely watched. Ultimately it is in the interest of developing countries to encourage investor confidence. Unless the domestic legal system is efficient and perceived as non-discriminatory, investors can practically only look to ISDS as an effective, depoliticised means of dispute resolution. Other alternatives such as political risk insurance add costs to doing business, and

stabilisation agreements also need effective enforcement. The mere threat of ISDS has in recent times also pushed countries to pursue dispute prevention policies, a positive agenda that can greatly benefit countries. In this context, the choice for developing countries is limited – either adopt ISDS or greatly improve their domestic legal environment to make domestic dispute settlement a viable alternative for investors. This can be complemented with implementation of initiatives to prevent disputes⁸. It is important to note that irrespective of signing agreements with ISDS clauses, investors can still have recourse to ISDS as a means of resolving disputes with the host country through creative structuring of their investments.

Increased market access and overall improvement in investor protection will benefit developing countries home to large and medium sized corporations engaged in cross-border transactions. Developing countries contributed to 39 per cent of global FDI outflows in 2013 as compared to 29 per cent in 2011. While investments from Africa increased by 57 per cent, largely based on increased outflows from South Africa, investments from Chinese corporations increased by 15 per cent⁹ in 2013. These countries have a growing interest in ensuring strong investor protection. China has concluded more than 100 investment treaties, many of them including high levels of investor protection and ISDS.¹⁰ India has signed investment treaties with countries such as Senegal, Bahrain, Trinidad and Tobago, Myanmar, and Mozambique, with the objective of protecting its own companies investing in these countries.

An apparent geopolitical implication of the TTIP and TPP arrangements is the stimulus they provide towards investment agreements between non-member countries (e.g. Regional Comprehensive Economic Partnership). Through these mega agreements, select countries of the world are aiming at writing the global rules on investment. This raises questions around the possibility of a more equitable outcome, had investment been a subject of multilateral deliberations.

⁷ For the purpose of this part of the paper, some publicly available investment treaties of non-member developing countries in Sub-Saharan Africa and the Caribbean have been reviewed.

⁸ Echandi, R and Kher, P (2014), 'Can International Investor-State Arbitration Disputes be Prevented? – Empirical Evidence from Settlements in ICSID Arbitration', ICSID Review, Vol. 29(1), p. 41-65.

⁹ Global Investment Trends Monitor, April 2014, available at http://unctad.org/en/PublicationsLibrary/webdiaeia2014d5_en.pdf.

¹⁰ Berger, Axel, 'China's new bilateral investment treaty programme: Substance, rationale and implications for international investment law making', American Society of International Law International Economic Law Interest Group, available at http://80.237.152.15/uploads/media/Berger_ChineseBITs.pdf.

International Trade Policy Section at the Commonwealth Secretariat

This Trade Hot Topic is brought out by the International Trade Policy (ITP) Section of the Economic Policy Division of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth – an association of 53 independent states, comprising large and small, developed and developing, landlocked and island economies – facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

ITP is entrusted with the responsibilities of undertaking policy-oriented research and advocacy on trade and development issues and providing informed inputs into the related discourses involving Commonwealth members. The ITP approach is to scan the trade and development landscape for areas where orthodox approaches are ineffective or where there are public policy failures or gaps, and to seek heterodox approaches to address those. Its work plan is flexible to enable quick response to emerging issues in the international trading environment that impact particularly on highly vulnerable Commonwealth constituencies – least developed countries (LDCs), small states and sub-Saharan Africa.

Scope of ITP Work

ITP undertakes activities principally in three broad areas:

- It supports Commonwealth developing members in their negotiation of multilateral and regional trade agreements that promote development friendly outcomes, notably their economic growth through expanded trade.
- It conducts policy research, consultations and advocacy to increase understanding of the changing international trading environment and of policy options for successful adaptation.
- It contributes to the processes involving the multilateral and bilateral trade regimes that advance more beneficial participation of Commonwealth developing country members, particularly, small states and LDCs and sub-Saharan Africa.

ITP Recent Activities

ITPs most recent activities focus on assisting member states in their negotiations under the WTO's Doha Round and various regional trading arrangements, undertaking analytical research on a range of trade policy, emerging trade-related development issues, and supporting workshops/dialogues for facilitating exchange of ideas, disseminating informed inputs, and consensus-building on issues of interest to Commonwealth members.

Selected Recent Meetings/Workshops Supported by ITP

15-16 December 2014: International Conference on 'Mega Trading Blocs: Implications for Developing Countries' held in New Delhi, India

5-7 November 2014: 7th South Asia Economic Summit (SAES VII): Towards South Asia Economic Union and the Launch of the Publication on *Regional Integration in South Asia: Trends, Prospects and Challenges*, held in New Delhi, India

14-15 October 2014: LDC IV Monitor's Launch of the Publication on the Implementation of Istanbul Programme of Action for LCDs, held in New York, USA

3 October 2014: Commonwealth-UNCTAD Discussion Session at the 2014 WTO Public Forum: *South-South Trade and Sub-Saharan Africa: Issues and Way Forward*, held in Geneva, Switzerland

5-6 May 2014: Regional Meeting on 'WTO and Post Bali Agenda', held in Dhaka, Bangladesh

28-29 April 2014: Regional Meeting on 'WTO and Post Bali Agenda', held in Accra, Ghana

24-25 April 2014: Regional Meeting on 'WTO and Post Bali Agenda', held in Nairobi, Kenya

10-11 December 2013: Regional Workshop on 'South-South Trade and Regional Value Chains in Sub-Saharan Africa', held in Nairobi, Kenya

5 December 2013: WTO MC9 side event: *Panel Session on Integrating Trade Issues in Post-2015 International Development Framework*, held in Bali, Indonesia

4 December 2013: WTO MC9 side event: *Discussion Session on the Future of Aid for Trade*, held in Bali, Indonesia

3 December 2013: WTO MC9 side event: *UNCTAD-Commonwealth session on Reflections on Global Trade: From Doha to Bali and Beyond*, held in Bali, Indonesia

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