Policy Brief No. 2/2011

Investment Provisions in Trade Agreements: Critical issues

Developing countries have been entering into a complex web of economic agreements going by the name of Free Trade Agreements (FTAs), Economic Partnership Agreements (EPAs), Comprehensive Economic Cooperation Agreements (CECAs), etc. A prominent feature of many of these is the inclusion of investment provisions as an 'article' or 'chapter', and sometimes as a separate agreement on investment, involving profound public policy commitments. Since these provisions then set the regulatory framework for foreign investments in the signatory countries and are legally binding on governments, it is crucial to understand their implications. This policy brief focuses on some of the key aspects that developing country policymakers have to bear in mind while entering into investment negotiations.

Implications of Investment Provisions

Core elements of investment provisions consist of: (i) definitional provisions that decide the "scope of application"; and (ii) operative provisions that deal with "standards of treatment" and "protection" of investments.

Box 1: Core Elements of Investment Provisions

(a) "Scope of application" through the definitions of:

- investment;
- investors; and
- policy measures affected by the agreement.

(b) General and specific "standards of treatment" of investments such as:

- national treatment;
- most-favoured-nation treatment; and
- performance requirements.

(c) "Protection of investments" through:

- protection against nationalisation and expropriation;
- compensation for expropriated investments;
- availability of dispute settlement system; and
- guarantee of free capital transfer.

Definitions are very important because they affect the impact of the operative provisions of the agreements. There can also be effects resulting from the interaction between investment provisions across different FTAs.

For example, once investments, investors and policy measures are defined in a particular manner in an agreement, national treatment means that the host country cannot discriminate between domestic and foreign investments thus defined, while applying any domestic policy measure. Further, most favoured nation commitment means that if some benefits or concessions have been provided to investors from some third country, investors from the foreign country party to the agreement must be treated just as favourably.

Investment agreements originally came into existence in order to guarantee the safety and returns on investments by multinational companies (MNCs) in developing countries through foreign direct investment (FDI). FDI has been favoured and promoted over other forms of capital flows because (unlike financial capital invested by foreign firms), FDI is expected to enable a host country to achieve faster industrial catching-up through technology transfer and increased export market access.

Host countries have used various incentives to influence the locational decisions of foreign investors and encourage investments into certain industries and activities, in exchange for performance requirements. These performance requirements (such as requiring increasing use of locally produced inputs or ensuring minimum exports or foreign exchange saving in the country concerned) have been required precisely because faster catching-up enabled by FDI does not occur automatically. Research on several country experiences has clearly established that only strategic use of FDI-related policy measures can ensure that foreign invested companies will establish substantial linkages with the domestic economy and that foreign-invested sectors will not become enclaves (often with exploitative labour relations and severe environmental impacts).

However, investment provisions in recent agreements lead to drastic erosion of such policy flexibility, and therefore the ability of developing countries to derive net benefits from foreign investments. This has come about due to the broadened "scope of application" and detailed "treatment" and "protection" provisions.

A. Scope of Application

In recent years, many North-South and South-South trade agreements have included broad definitions of investment. A broad definition typically states that "investment means every kind of assets" and covers equities, securities, loans, derivatives, sovereign debt, as well as a wide range of intangible assets. Apart from FDI, such a definition covers investments by portfolio investors, private equity, hedge funds, etc. Intangible assets include: traditional intellectual property rights such as patents and copyrights; management and consultancy rights; business concessions including concessions for natural resource scoping and extraction; etc.

Such broad definitions are problematic. For instance, including intellectual property rights (IPRs) in the investment definition and thus granting it additional protection leads to an erosion of the hard-won flexibility gained by developing countries under the WTO Agreement on Trade Related Intellectual Property Rights (TRIPS), especially for ensuring availability of patented medicines at affordable prices.

Similarly, including portfolio and other speculative investments and financial assets such as sovereign debt or loans to state enterprises in the definition of investment has the following adverse implications:

- The host country will be extending preferential conditions of entry and operations to various classes of investors (e.g., private equity funds, venture capital funds, hedge funds, and other entities involved in speculative investments) who do not either bring in FDI-type ownership advantages to the host companies or contribute to national investments even in the medium term, as they are known to sell and move out.
- Including sovereign debt in the definition can lead to disruptions in attempts to restructure sovereign debt even when this is clearly required.
- Given the provision for guarantee of free transfer of funds associated with investments, a broad definition will also erode the ability of the host country to regulate different forms of capital flows. These protection provisions mean that host country governments can be sued even by investors in any of these financial assets as well as by sovereign bondholders (apart from foreign direct investors), by deeming legitimate regulatory policies as expropriation.
- This can lead to periods of financial market volatility and macroeconomic instability, with severe adverse impacts on the real economy and employment as seen in various crises, including the recent global one.

These problems arise also when investment is defined to be "*made in accordance with the domestic law of the host-state*", if the Parties to the agreement have broad asset-based national FDI definitions.

Another aspect of the scope of application of an agreement relates to the definition of investors who will be considered as investor of a Party to the agreement and as thus enjoying the privileges under the treaty. A definition based on "country of incorporation" alone should not be used, given that investors from non-Parties can benefit from the agreement simply by incorporating their company under the laws of a Party. Therefore it is important to specify that a company incorporated in one contracting Party could be protected by the other Party, provided that the seat of control of the company is located in the other contracting Party, or if there is control or substantial interest in the company by the nationals of the other Party. Investments should then be defined as "investments made by investors (as defined) as part or all of a business or commercial operation with significant physical presence of the investment in the host Party".

Given that interactions with the national treatment provision expose domestic enterprises to direct competition from foreign investors thus defined, scope of application provisions should build in qualifications based on sectors, scale of investment, etc. to retain regulatory flexibility over strategic sectors and small scale enterprises that are necessary for national development. In services, governments should not commit liberalisation in public utilities such as power, water, etc., which are basic to the human development needs of the majority of their populations, not even in exchange for gaining increased market access for a few of their domestic service sector exporters. It is also crucial that countries explicitly keep financial services out of the list of services sectors covered under the agreement. This is because allowing the entry of foreign financial service providers will increase the problem of financial instability and curtail government's ability to regulate capital flows.

B. Treatment of Investment

National Treatment

Post-establishment national treatment means that unless otherwise specified, the host Party will grant all investments from the partner country, treatment '*no less favourable*' than that it accords '*in like circumstances*' to investments by its domestic investors. That is, once they are set up in the host Party, foreign-invested companies and domestic companies have to be treated alike in terms of all national policies, unless exceptions are specified.

Under a "negative list" approach to national treatment, Parties have to explicitly list the industries or activities that it does not want to liberalise, as well as list policy measures where national treatment will not apply. This means that national treatment will apply to everything else outside the negative list. This is problematic because circumstances can arise in the future that a country will find itself unable to refuse national treatment to certain foreign investors (even if changed circumstances warrant it) and will come under dispute, because a particular industry/activity/service or a particular policy affecting investment was not included in the "negative list" at the time of signing the agreement. This can even happen when the activity concerned did not exist earlier and so could not have been explicitly excluded, as WTO case law has shown.

Therefore national treatment should be granted only on a "positive list" basis, under which all those sectors/activities that a country is willing to liberalise are listed. Even in the covered sectors, policy measures where national treatment will not apply should be specified. In particular, it should also be specified that measures taken in accordance with government procurement policies at any level of government will not be considered as violating national treatment.

National treatment is sometimes defined to include the "pre-establishment" phase. Since this means that domestic and foreign investments have to be treated alike before they are even established in the host Party, this will automatically take away host countries' right to regulate the *entry* of foreign investment. Pre-establishment national treatment should not be granted even using a positive list (i.e., selective liberalisation of entry in specific activities or industries), because in changing circumstances it might be necessary for host governments to place limitations on admission and establishment of investments. This will become impossible once pre-establishment national treatment is granted.

Box 2: Some factors that warrant host country flexibility for investment regulation are:

- employment outcomes;
- technology transfer;
- environmental impacts;
- defence capabilities; or
- other strategic development concerns.

Most Favoured Nation Treatment

MFN treatment means that a host country must extent to investors from a contracting Party, the same treatment or treatment '*no less favourable*' than it accords '*in like circumstances*' to investors from any other country. Given that foreign investors from different countries therefore have to be treated alike, MFN clauses in bilateral and regional agreements are interpreted to mean that the highest standards (in terms of preferential treatment) in one of them have to be extended to Parties to other agreements. Since a number of important countries are currently members of various regional agreements, unqualified MFN clauses will facilitate cross-regional harmonisation covering more and more countries and establish a level playing field for foreign investors. Therefore, "*MFN treatment that one of the Parties grants to investors from third Parties owing to their membership of a free-trade area, customs union or regional agreement – whether already in existence or to be signed in the future*", should be explicitly excluded. MFN treatment preferences stemming from agreements signed by Parties relating wholly or mainly to tax matters should also be excluded.

Performance Requirements

By prohibiting performance requirements for investments originating in the signatory countries, investment provisions seek to liberalise the "conditions on investments". In order to retain the existing policy space for meeting the development objectives from FDI, it is necessary not to expand the list of investment measures in FTAs beyond those included in the Agreement on Trade-related Investment Measures (TRIMs) at the WTO.

In the context of services, a framework for liberalising existing regulatory regimes is achieved by removing measures currently in place and by committing not to introduce measures in the future. Countries should not make any such commitments. In particular, they should not go beyond their existing commitments under the GATS.

Overall, provisions for reviewing national treatment, MFN treatment and/or conditions of investment should be incorporated and be explicitly linked to domestic economic circumstances and capability at the time of review. Further, the following should be explicitly specified:

- Foreign investor rights are strictly limited;
- Any laws, regulations or measures adopted to protect public safety or promote the public interest at the national and sub-national levels are fully exempt; and
- No provision in the agreement, including "*fair and equitable treatment*" under "*minimum standard of treatment*" should be interpreted to mean to go beyond domestic law, or the granting to foreign investors of any rights in the host country greater than those of its own nationals.

C. Protection of Investment

Expropriation and Compensation

It is crucial to define the terms of coverage of expropriation to include only "direct" expropriation. Direct expropriation refers to nationalisation, transfer of title, or seizure of private property by the host government.

A liberal definition of expropriation prohibits both direct and "indirect" expropriation. Indirect expropriation has been defined in some agreements as "*expropriation by measures equivalent (or tantamount) to expropriation or nationalisation*". This has been interpreted to mean "change in foreign investors' business profitability or prospects" resulting from any policies or regulations imposed by the host Party. This implies that legitimate regulations at the national, sub-federal and local governments can be brought under litigation for affecting the profits of the investor. Therefore, indirect expropriation should not be included.

Dispute Settlement

Most investment agreements state that the host Party can be sued at international arbitral forums if it does not comply with any of its obligations under the agreement and investors can claim compensation from the state. Arbitration is typically referred to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention), or the Model Law on International Commercial Arbitration of the UN Commission on International Trade Law (UNCITRAL). There are serious problems with investor-to-state (e.g. NAFTA) and also state-to-state (e.g. WTO) dispute settlement channels, which have repeatedly adjudicated in favour of foreign companies and developed countries. So developing country trade negotiators need to be cautious that they do not to make commitments in the provisions relating to scope or treatment, which can affect them adversely.

Freedom for Capital Transfer

Investment agreements require all transfers relating to investments from contracting parties to be allowed "*without delay*" into and out of their territories. Typically, use of capital controls is allowed only as defined under the "safeguard measures" in each agreement. These allow capital controls only under emergency situations such as in case of "*serious difficulties*" with monetary policy, exchange rate policy, or balance of payments, and that too only "*temporarily*". Clearly, this prevents countries from making use of different capital control measures, which may be necessary to *prevent* serious difficulties. Therefore, sufficient policy flexibility to retain existing capital controls and to introduce new ones should be built in.

Note: A detailed discussion of the issues covered here can be found in 'Rethinking Investment Provisions in Free Trade Agreements', available at: http://www.networkideas.org/alt/may2011/Investment_Policy_Note.pdf