International Investment Agreements and their Implications for Developing Countries

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1. Summary

WWF is an international non-governmental organisation that works to preserve biodiversity by protecting species and habitats, preventing destructive resource use and reducing pollution. We are currently active in over eighty countries worldwide.

WWF has worked for over 10 years on trade and investment issues, and has carried out extensive research into structural adjustment and macroeconomic reforms [1]. WWF was heavily involved in the debates around the OECD Multilateral Agreement on Investment from 1996 until negotiations collapsed in late 1998. Currently, we are active internationally in the preparations for negotiations at the World Trade Organisation (WTO), and regionally in negotiations on the Trans-Atlantic Partnership (TAP), Free Trade Area of the Americas (FTAA) and the proposed Mediterranean Free Trade Zone (MFTZ).

This presentation draws on this experience, and also from analysis by many other non-governmental organisations working on development, human rights, and labour rights issues in both developed and developing countries.

These groups are sceptical about the bold claims made for foreign investment as a development panacea. Noting that in the past two decades, as trade and private investment flows to developing countries have risen faster than global incomes, this has failed to trickle down to the poorest communities. Inequality has tended to rise both within and between nations, and absolute numbers in poverty have increased [2]. Between 1960 and 1994, the ratio of the income of the richest 20 percent to the poorest 20 percent, has increased from 30:1 to 78:1 [3]. At the same time economic growth is driving worsening global environmental trends in key areas such as: soil fertility, fish catches, climate change and freshwater availability [4].

Our analysis, which is laid out in detail below, leads us to believe that much of the current debate on foreign investment is overly simplistic, and fails to adequately address the issues of poverty reduction and the achievement of socially and environmentally sustainable development.

Both governments and investors have tended to pursue narrow, short term economic interests, often at the expense of environmental and social welfare. This leads to overly-heightened competition for investment inside an inadequate system of international regulation. The resulting systemic failures encourage inequitable and inefficient development, and undermine progress towards sustainable development.

However, like the majority of other NGOs, WWF does believe that greater international investment can bring substantial benefits to developing countries, particularly in terms of the transfer of resources

(financial, technical and human). However, this positive outcome will only occur inside a comprehensive regulatory framework that promotes sustainable development and ensures environmental limits are preserved.

Of course, any framework for investment regulation will not - and should not - aim to solve all the world's problems. However, it should ensure that international investment flows and rules support, rather than undermine, other legitimate policy goals.

The vast majority of NGOs engaged in these issues do not believe that such a framework can be negotiated at the WTO. The WTO has failed to show it is able to balance conflicting social, environmental and economic interests in the past; is insufficiently democratic in its processes; and at a technical level has no competence to handle investment issues.

In contrast, Earth Summit III in 2002, and the meetings of the UN General Assembly and Commission for Sustainable Development on trade and investment preceding it, present an opportunity to systematically examine the relationship between investment and sustainable development. This process provides an appropriate, legitimate and existing forum to discuss a broad framework for regulating international investment.

The implementation of such a framework will occur at different levels - multilateral, regional, and national - but the appropriate balance must not be pre-empted by handing negotiations to the WTO.

Instead, all countries - not just the OECD - must have an adequate opportunity to consider their priorities in this area and decide the scope, composition and timing of any new negotiations and related initiatives.

2. The Role of Foreign Investment in Sustainable Development

At the Rio Earth Summit in 1992 the international community agreed that sustainable development - the balancing of economic, social and environmental objectives - is the ultimate aim of the development process.

Agenda 21 - the specific action plan agreed at Rio - argued that all forms of international financial flows, both public and private, should be reorientated to meet these objectives. However, little has been done to achieve this in practice, especially inside bilateral or international economic agreements.

This will have to change if progress is to be made towards sustainable development. Private finance is becoming ever more important, dwarfing official aid flows in most areas outside sub-Saharan Africa. Without balancing policies to regulate private investment flows, the billions of dollars invested by NGOs each year in developing countries will make little impact on overall levels of poverty and environmental degradation.

To this end, NGOs see that foreign investment flows should support the following broad objectives:

- **Promote pro-poor growth**: foreign investment should help reduce income inequalities and marginalisation of poor communities, enhance basic labour rights and ensure gender inequalities are addressed.

- **Be encouraged to flow to less developed countries**: foreign investment flows are concentrated in a handful of developing countries. Active steps must be taken to promote appropriate investment in traditionally less attractive destinations, which can provide commercial economic returns.

- **Ensure efficient and sustainable use of natural resources**: given the importance of foreign investment flows to developing countries in primary sectors, and associated processing and financing activities, it is vital that countries and communities gain fair rents from their exploitation, and that resources are managed in the long-run interest of the host country.

- **Minimise pollution and environmental damage**: foreign investment has a complex interaction with environmental quality, being associated with both large scale damaging development (for example, mining, forestry, fisheries, textiles), and with the transfer of new clean technologies to developing countries (especially in power generation, manufacturing and services). It is vital that negative impacts are reduced and positive linkages promoted.

Obviously, a large part of the burden of responsibility for ensuring that the benefits of foreign investment are maximised, and costs minimised, lies with the host country. However, many developing countries lack the institutional capacity to achieve this, especially in the field of economic, labour and environmental regulation. Moreover, fierce international competition for investment places restrictions on the bargaining power of host countries, and means that the benefits of inward investment are reduced through subsidies (eg. tax holidays, customs relief, lower labour standards).

Home countries must also take responsibility for the impact of their investments, given their stated commitment to the objectives of sustainable development. For the whole of Africa 95% of FDI comes from OECD countries; dominated by France, the UK, the United States and Germany. The largest share of these investments go into the primary sector (for example, 52% for France and 53% for the United States) [5]. The main new drivers of investment outside the primary sector are infrastructure development and privatisation, both of which have been heavily promoted by international institutions such as the World Bank.

However, the record of negotiations on investment, especially the OECD MAI and proposals for the WTO, seem to show that OECD countries are reluctant to seriously address these issues inside investment frameworks. In fact, investment agreements seem solely concerned with increasing access on favourable terms for OECD Trans-National Corporations (TNCs), and virtually ignore the need to promote balanced development in host countries.

Even if no negotiations start at the WTO on investment, these issues will arise in regional fora: for example, for North African countries in the context of the proposed MFTZ with the European Union, and for South American countries under the FTAA. Therefore, it is vital that the actual contribution of foreign investment to balanced development is clearly understood by all countries, along with the implications of any proposed investment agreements.

Key issues in making FDI support sustainable development

The current policy consensus around inward investment tends to portray its impacts in glowing terms, especially in transferring technology, creating jobs and stimulating managerial efficiency. However, this perception is based on very little detailed analysis of either how such benefits occur, and can be maximised, or on the potential associated costs of FDI.

This is in stark contrast to development debates of earlier decades, and to the strategic and measured approach to foreign investment taken by many of the successful Asian economies before the mid-1990s. The global financial crisis has concentrated attention on the potential negative impacts of short term financing. However, this is often linked to more long-run investment, which can also help create structural macro-economic problems such as balance of payments deficits.

Even in the United Kingdom, the largest recipient of FDI in Europe and second largest global investor, questions are now being asked as to the long term employment and growth benefits of high profile investments supported by public finance.

WWF considers the following issues to be uppermost in assessing the impact of FDI:

- **Strength of links to the national economy**: in many countries foreign investment operates virtually autonomously with few links to the national economy, except through tax revenues and some employment. This is particularly the case in export orientated sectors such as agriculture, mining and oil extraction, and some forms of manufacturing- particularly assembly plants and light manufacturing for export. The trend towards resort tourism, with self-contained centres relying on imports and generating minor levels of local employment, is particularly relevant in many countries.

- **The direct costs of attracting FDI**: competition for FDI has increased, especially between different locations inside regional trading blocks. In general, developed countries tend to offer up-front fiscal incentives coupled with infrastructure subsidies, while developing countries rely on tax and duty exemptions due to a lack of available hard currency. Even more worrying is the trend towards lowering labour and environmental standards to attract and retain investment, especially in free trade zones [6]. These tend to place the costs of attracting investment on the poorest, while fiscal incentives place the burden more widely in society. The cost effectiveness of such subsidies is widely contested, if under analysed, mainly because the indirect benefits from investment - such as efficiency spill-overs - are hard to measure.

- **Competition with local firms**: traditionally the main reason for excluding foreign investors was to protect domestic firms (the infant industry argument). This policy failed to produce efficient development where competition was poor (eg. Latin America), but succeeded where limited entry provided a spur to domestic innovation (eg. South Korea). Competitive disadvantages of host country firms are increasing due to the economies of scale of incoming TNCs in terms of globalised production processes, technology, brand strength and cash flows from mature domestic markets. In the absence of effective international competition regulations, the use of restrictive business practices and cartels by TNCs is also a growing concern. The amount of flexibility host countries are given by investment agreements to manage these issues in line with their development priorities was a major issue in the MAI debate, and is examined in more detail below.

- **Community development**: in many countries initiatives are growing to decentralise, and ensure greater local control of natural resources and development of economic capacity. Incoming investors are often in conflict with such initiatives due to their scale and market power. Especially in sensitive sectors such as tourism, where locals are likely to be excluded from benefiting from the economic value of their environment if they have to directly compete with outside investors.

- **Levels of reinvestment**: in primary sectors it is essential that countries receive a fair rent on their resources, as this promotes efficient use and allows reinvestment in higher value-added areas. Traditionally this was often achieved through mandatory joint ventures with national firms, but use of this instrument is now restricted by some BITS, and may be limited in the upcoming review of the TRIMS agreement, as this was a proposal in the OECD MAI. Alternative ways of capturing rents through concession fees and taxes have often proved difficult to apply in sectors such as oil, forestry and fisheries [7].

- **Technological transfer**: FDI is often promoted as a way of improving technology transfer and upgrading local management and skill levels. This is certainly a potential, but will not automatically arise unless a firm is integrated into the host economy. There has been particular interest in how environmentally sound technologies may be transferred to domestic producers, but results have shown this to be highly dependent on host country regulatory conditions, pressure from civil society in the home and host country and the scale of operations [8]. Implementation of proposals such as those contained in the OECD MAI to outlaw mandatory technology transfer provisions on incoming investors would only make this process more difficult.

- **Cultural issues**: some of the most contentious debates in the MAI were over cultural issues, and in particular the insistence of US film makers of receiving open access to markets in non-English speaking countries; particularly France and Canada. Similar debates are playing out elsewhere, such as a dispute over allowing McDonalds into Bermuda. In a globalising world cultural issues assume more - not less - political importance, yet are hard to reconcile with many liberalisation proposals.

The above points show that there are many vital choices to be made when assessing the costs and benefits of particular foreign investments. In some sectors choices may be relatively straight forward; for example, high technology manufacturing with no local competitors. While elsewhere complex social and environment issues will have to be assessed; for example, large scale agro-business investments in existing export industries dominated by small producers.

Many of these key development issues were not considered by OECD countries negotiating the MAI because their economies are at relatively similar levels of development. However, they still filed over 1000 pages of exceptions to that proposed agreement. Perhaps the strongest argument for maintaining a regional approach to investment is that countries involved are more likely to share similar development concerns and thus negotiate a more appropriate agreement.

The history of past international negotiations on investment shows that major developmental issues have been neglected, and the structure of agreements has been driven by OECD countries wishing protection and access for their investors.

Any agreement at the WTO is likely to follow the same path as developing countries have not had the time to prepare an alternative multilateral framework for investment that would suit their needs and priorities.

3. Foreign Investment, Environmental Quality and Natural Resource Use

WWFs main area of expertise lies in environmental protection and sustainable natural resource use. As well as working at the national, regional and international policy level, we have been instrumental in helping set up two global eco-labelling schemes in forestry and fisheries (the Forest Stewardship Council and Marine Stewardship Council). We are also working with companies in the tourism, mining and oil extraction sectors to improve environmental behaviour, and are building a programme on the transfer of clean technologies in the energy sector.

In the most general terms, the excessive use of natural resources stems from the fact environmental goods and services undervalued, or treated as free. This causes a distortion in economic incentives and their subsequent overuse by economic agents (producers and consumers). Under such circumstances, enhanced international trade and investment exacerbates the existing inefficient allocation of scarce environmental resources, and may mean that the overall welfare implications of FDI are ambiguous in environmentally sensitive sectors.

However, the debate on FDI and the environment is usually simplified into three myths:

- **FDI raises incomes, releasing funds to be spent on environmental improvement**: this effect has only been observed for a limited group of urban pollutants, other environmental trends worsen with income growth. The turning point even for those pollutants which stop rising with income is estimated to be $8000 per capita [9].

- **FDI has higher environmental performance than domestic investors**: this is true for some pollutants emitted by particular high-technology industries. However, it fails to account for: the scale impact of FDI relative to the local environment and regulatory capacity - especially in natural resource sectors; sectors where there are no comparable domestic firms; and the use of polluting sub-contractors by TNCs.

- **TNCs have not been shown to relocate to areas with lower environmental standards**: at the aggregate level this traditional pollution havens effect has not been observed, but in polluting and natural resource using sectors there has been significant relocation to countries with lower standards. Additionally, companies receive exemptions from regulations before establishment, and once established due to the threat of disinvestment. However, environmental regulation is usually not the primary driver for location in a trading region, but can be vital in making investment location choices between countries in the same trading region, and between different locations in the same country

The most significant effect of competition for investment between, and within, countries may not be an overt race to the bottom in environmental standards, but the fact that regulation and its enforcement fail to improve over time. Currently, no country effectively internalises the environmental costs of economic activity, and there are many examples of where competition for FDI has been cited as a reason for not introducing new environmental regulations or taxes. Dealing with this requires countries to coordinate together at different institutional levels in order to ensure environmental standards can be raised.

Water Use and Foreign Investment
The difficulty of addressing environmental issues in a globalised world is clear to see in the case of water use. Currently, one third of the worlds population lives in countries experiencing water stress and this number is rapidly growing. About 38% of global cropland is degraded, and productivity losses may reach 20% in some arid countries. Arid and semi-arid countries are experiencing the highest pressures, which will be exacerbated by continuing climatic change.

Competition for both land and water is increasing. In some Asian countries loss of crop land to industry and urban development has occurred at the rate of 1% per year. Irrigation has accounted for more than half the increase in global food production since the mid-1960s, but about 20% (50 million hectares) is suffering from soil degradation due to faulty practices. Agriculture uses 86.8% of water in developing countries, but only 46.1% in the developed world. As countries develop industrial and domestic use will expand, at the same time as more irrigated land is needed to feed rising populations. Given that humans already use around 50% of all the world=s available freshwater supplies, shortages and conflicts between uses are inevitable unless resource efficiency is improved [10].

However, given international competition for investment (and trade) governments find it hard to internalise these costs if it is seen as making them uncompetitive relative to other destinations. For example, in heavy water using sectors attractive to FDI such as manufacturing, export agriculture, tourism and golf course development, incoming investors tend to have priority access to available water supplies. This often has devastating impacts on local communities and ecosystems, and undermines subsistence activities which also compete for that water supply.

Mining in the Asia-Pacific Region
International competition encourages countries to lower, or fail to enforce, environmental standards in order to attract investors. For example, throughout the Asia Pacific region standards have been lowered in the mining sector - e.g. copper, gold, iron ore, coal, aluminium, bauxite, lead, silver, tin, zinc - to attract outside investment. Mining in Indonesia is carried out under special Contracts of Work (COW) which generally exempt mining corporations from environmental laws. Similarly, in Papua New Guinea almost all mining operations operate under special conditions which impose minimal or no environmental regulation. More recently the Philippines made radical changes to their mining law, creating a massive upsurge in applications from foreign investors for mining leases. In all three countries, exemptions have been made to domestic law to accommodate major mining disasters [11].

Lax enforcement of regulations can emerge from deliberate national decisions, as with Indonesia above, or from local decisions. As many natural resource industries operate far from centres of government there is both a weaker government infrastructure, lower oversight of decisions and greater opportunities for corruption than in other sectors.

The end result is an excessive use of resources by both domestic firms and increasingly by international companies. Increasing trade and investment without parallel increases in regulatory capacity adds to the unsustainable use of such resources by increasing potential market concentration and the rapidity of economic change.

Increased flows of trade and the investment can exacerbate the existing inefficient allocation of scarce natural resources, if they are not matched by adequate regulation at all levels. This implies that economic benefits will be coupled with environmental and social costs, particularly to the most disadvantaged, and the long term welfare implications of increased FDI will be ambiguous, especially in environmentally sensitive sectors.

4. Existing International Frameworks for Investment

The sections above have laid down broad objectives for any investment framework, and outlined some of the problems which need to be overcome, particularly in the sphere of environmental protection. The following sections examine how existing investment frameworks deal with such challenges, if at all, and then outlines a set of new priorities for international regulation.

Compared to most national or regional investment flows, international investment is relatively under-regulated. Most binding agreements at the international level are instruments for investor protection (eg. compensation for expropriation), investor treatment (eg. national treatment, outlawing performance requirements) or increasing the access of foreign investors to certain sectors (eg. sectoral liberalisation, removal of technical barriers).

Outside regional economic agreements such as NAFTA and the European Union, the primary instruments for achieving these deregulatory objectives have been Bilateral Investment Treaties (BITs) signed between two sovereign states. In 1997 there were 1,517 BITs, up from around 500 in 1989. BITs have varying scope and complexity, and have been signed between countries at all levels of development: 48% between developed and developing or transition economies; 45% between developing countries themselves or with transition economies [12].

Several areas of investment liberalisation and investor treatment are also dealt with in the General Agreement on Trade in Services (GATS) and the Trade Related Investment Measures agreement (TRIMs), administered by the WTO. Unlike most BITs, the GATS and TRIMs agreements do not allow foreign investors to directly challenge states for failing to fulfill their treaty obligations.

The proposed OECD Multilateral Agreement on Investment (MAI) aimed to combine the most investor-friendly parts of these previous agreements, inside a framework aimed at total liberalisation (no new non-conforming laws and progressive rollback) with direct investor-state dispute settlement [13]. A similar, if less far reaching, agreement has been proposed for the next round of WTO negotiations by the European Commission [14].

The European Commission proposals are still in draft form, and there have been suggestions from Member States that they will have to evolve in order to avoid the mistakes of the OECD-MAI. However, it is unlikely that any agreement will gain political support in the OECD which does not contain significant new levels of liberalisation for developing countries.

These instruments aim to promote greater FDI by limiting the ability of sovereign governments to discriminate against, or limit the actions of, incoming investors, and by providing more investment protection than is available in national courts.

In contrast, only rudimentary efforts have been made to construct international regulation in other areas where national governance might be limited. The most sophisticated system of treaties covers transfer pricing and double taxation issues. However, even given the extent of these instruments TNCs seem to be increasing efforts to avoid taxation through transfer pricing. In 1994 the US tax authorities made $3.5 billion worth of tax adjustments because of transfer pricing irregularities. In a recent UNCTAD survey 84% of developing countries surveyed felt that TNC affiliates in their countries were shifting income to avoid tax liabilities [15].

The only other binding international regulatory instrument is the OECD agreement on combatting bribery and corruption, which entered force in February 1999. Other processes on business practices, environment and labour are voluntary or lack strong implementation mechanisms [16].

As with any market, the lack of adequate international regulation over FDI should be expected to result in economic inefficiency and lower consumer and public welfare. Therefore, investors will tend to exploit different investment regimes to minimise tax bills, externalise social and environmental costs and distort markets through restrictive practices.

Current international agreements on FDI do not balance limitations on national sovereignty with enhanced international regulation. This imbalance undermines the pursuit of sustainable development, reducing the value of FDI to host economies and fostering inefficient investment and damaging management decisions.

5. Investment Promotion Agreements: balancing flexibility and investor confidence

The aim of BITs and other investment agreements is to promote greater investment flows by liberalising investor access and increasing investor confidence in the safety of their investments. Basic capital allocation theory argues that greater flows should increase total economic output by ensuring available capital is used most efficiently.

However, the same theory also shows that investment promotion is not sufficient to raise efficiency in the absence of true competition and adequate regulation. Regional and WTO agreements sometimes attempt to address broader efficiency questions by limiting subsidies or policy competition to attract investment, but such efforts are still at a very early stage.

Causes and determinants of FDI flows

Studies tend to show that effective investment protection and liberalisation are necessary, but definitely not sufficient, to stimulate FDI flows. The destination of FDI is mainly driven by potential market growth and access to cheap factor inputs, which accounts for the dominance of China as a destination for FDI.

There is some evidence that - despite having liberalised - African countries receive relatively low levels of FDI given their resource base and market size. This may be due to low investor confidence in local legal systems, because Africa lacks a strong regional investment source (cf. Hong Kong and China) or that economic growth projections are weak [17].

The economic arguments for investor protection disciplines and liberalisation are therefore different. Investor protection aims to create an environment where investors have confidence they will receive an adequate return on their capital. Investor liberalisation treaties codify the level of access to the host economy, without providing any extra motivation for FDI flows.

The rationale for governments to sign-up to international investment protection agreements is mixed. Governments lose potential advantages from policy flexibility, but may gain increased flows because investors will have increased confidence in their legal environment. However, the actual magnitudes of these two effects, and thus the size of any trade-off, is very hard to determine. Policy flexibility may be used wisely to promote economic development, or may result in inefficient protectionism. High levels of investor protection may just increase the profits of investors who would have come anyway, lowering net economic benefits to the host country.

Investors themselves tend to prioritise market access agreements over investor protection disciplines, which is a marked change from the 1970s when the fear of nationalisation was strong. A recent meeting of European Union businesses showed an ambivalence for multilateral rules on expropriation, performance requirements and profit repatriation. On the other hand companies did want negotiations on increased market access - especially to other developed countries - transparent and consistent rules in the host country, and would value extensions in competition policy. Fears were also expressed that investment rules could limit existing access to developing countries, and reduce companies= negotiating power [18].

Overall investment promotion rules restrict the rights of governments, while seemingly providing few obvious benefits in the way of increased incentives to investors. However, those companies responding to such surveys tend to have an existing business competence in dealing with the risks of FDI, and perhaps do not represent the views of other companies who have yet to invest abroad and therefore may value international protection more highly.

Conflicts between liberalisation and policy flexibility
There are three possible explanations for the reluctance of the majority of countries to liberalise completely and provide equal treatment to all investors: existing investors, whether domestic or foreign, may wish to limit competition; foreign investors have specific differences compared to domestic investors in some sectors (eg. cultural industries); open access to foreign investors may conflict with other policy objectives, such as building domestic industrial capacity.

The form of existing investment promotion agreements does not differentiate between these reasons, but sets a framework of legal parity (National Treatment) where foreign investors cannot be treated less well than domestic ones, but may be treated better. There is no attempt to assess the economic parity between foreign and domestic investors, or whether competition would be Afair≅ based on market characteristics; such as capitalisation, size, technology, brand name etc.

In order to accommodate issues of economic imbalance, or to preserve other national policy goals, investment agreements allow flexibility in their provisions. This may be achieved in many different ways, such as explicitly nominating those sectors to which the agreement applies, or specifying exceptions from their provisions [19]. The extent of these flexibilities is decided by the relative bargaining power of countries in negotiations. There is no rational framework for comparison; though general exceptions for national security are usually included.

However, both theory and practice show that the extent of liberalisation must necessarily be limited by other policy goals, especially in the absence of adequate international and domestic regulation. Each sphere of sustainable development - economic, social and environmental - requires international markets to be limited to some extent. The needs of development, competition and human rights potentially justify limits in the economic arena; maintenance of local cultural diversity and community economic control may necessitate limits in the social arena; potential irreversible impacts and maintenance of communal-use rights provide a rationale for limits in the environmental sphere.

Limiting liberalisation, whether permanently or temporarily, is often unfairly dismissed as a second-best policy option compared to changing domestic policies; for example, improving domestic competitiveness, increasing skill levels or raising regulatory enforcement levels. However, it is often the only feasible policy option given the development level and fiscal capacity of many countries.

As limiting liberalisation incurs the cost of rejecting extra investment it will obviously not be taken lightly by any government. However, investment agreements - and their negotiators - often seem to assume that countries will always use policy flexibility unwisely. Arguing that even if there are potential development gains from restrictions on FDI such powers will be abused and so should be restricted through international disciplines. However, over 90% of recent unilateral changes in investment laws have been liberalising, not restrictive [20]. Therefore, it is more likely that governments are precipitously abandoning necessary limits rather than imposing too many.

Existing agreements deal with these limits to investment liberalisation in an ad-hoc way, and give governments few rights to pursue non-liberal policies. In the OECD-MAI negotiations these conflicts aroused public opposition because the major extensions to investor protection intruded into many new areas of national decision-making [21]. The sections below give examples of this by detailing the conflicts between the OECD-MAI and environmental sustainability.

Investor protection and liberalisation agreements must recognise the necessary limits to liberalisation in a systematic and coherent manner that subordinates investor rights to legitimate national sovereignty and the achievement of sustainable development.

6. Learning from the OECD-MAI: avoiding potential conflicts between investor promotion agreements and environmental legislation

The OECD-MAI was analysed for its impact on environmental legislation by the OECD Secretariat and national governments as part of a coordinated process initiated in December 1997. These reviews showed that there were significant conflicts between the OECD-MAI and both multilateral environmental agreements (MEAs) and national environmental legislation, which had not been addressed in four years of negotiations [22].

The OECD-MAI clashed with MEAs which aim to ensure that the benefits of environmental protection are spread evenly between Parties, and not allocated purely by market forces. The Rio principle of "common but differentiated responsibility" allocates obligations and benefits between countries on the basis of their level of economic development. These distinctions, which include financial resource and technology transfer obligations, can translate into discrimination between investors. Examples of OECD-MAI conflicts with MEAs include [23]:

- The Convention on Biological Diversity (CBD) mandates the use of Abenefit-sharing agreements≅ under which the profits from exploiting genetic resources will be split between national governments and the - usually foreign - companies which directly exploit them. Experience of such agreements is that they tend to be constructed in a way that would have conflicted with MAI provisions.

- The United Nations Convention on the Law of the Sea (UNCLOS) empowers states with extensive sovereign discretion over the conservation and management of their territorial waters and Exclusive Economic Zone. Its rules anticipate developing coastal states being entitled to require compensation from foreign fishing fleets to support financing and technology related to the fishing industry. States may also require the use of local ports, personnel and the landing of fish in local markets, conflicting with OECD-MAI rules on non-discrimination and performance requirements.

The potential for such conflicts was recognised in both papers by the OECD secretariat and individual country analysis, for example by the UK and South Korea. However, even at the time negotiations finished there were no proposals for dealing with these conflicts.

The OECD-MAI threatened legitimate national environmental regulation in three ways. National Treatment rules prevented discrimination against foreign investors in order to protect the environment (*de jure* discrimination); for example, requirements for higher environmental bonds; information on environmental performance abroad; and exclusion from environmentally sensitive sectors such as toxic waste disposal. Secondly, National Treatment rules allowed investors to challenge regulations which while not openly discriminatory, have the effect of discriminating (*de facto* discrimination). This could affect regulation of new processes such as biotechnology, and evolving regulatory frameworks which require the use of the latest environmental technologies.

Thirdly, rules on expropriation exposed governments to challenges from investors which claim their profits have been taken away by the imposition of an environmental regulation. Such expropriation provisions already exist in NAFTA. For example, this led a US company, Metalclad, to sue the Mexican authorities for expropriation, because a toxic waste dump they purchased was not allowed to re-open after a further impact assessment revealed it lay over a vulnerable aquifer [24].

Any international or national rules which aimed to spiral up environmental performance by requiring international investors to operate to minimum standards which may exceed local levels, would fall foul of similar rules which interpreted Anational treatment≅ rigidly.

It has been suggested that a general exception for environmental legislation, similar to Article XX of the GATT, could be included in any future investment agreement to remove such problems. However, experience with the GATT XX has shown its interpretation to be unclear and biased towards maintaining liberalised markets. New processes are needed to balance environmental and economic priorities, which are based on agreed international norms such as the polluter-pays-principle, precautionary principle and prior informed consent [25].

Official environmental assessments of the OECD-MAI showed that such binding international investment rules could conflict with both MEAs and national environmental laws. Any future international rules on investor protection must avoid such conflicts and ensure recognised principles of environmental law are respected.

Conflicts between investor protection agreements and the sustainable use of natural resources
Many countries registered exceptions from the OECD-MAI over the control of natural resources [26]. These included provisions on second home ownership, land purchase, access to certain agricultural sectors and types of natural resources. The aim of many such policies is to improve environmental management by ensuring that countries and local people gain direct income and employment benefits from their natural resources. Similar laws are integral parts of many of conservation projects run by WWF and other agencies, but could have been challenged under the MAI as discriminatory.

As described above, it is particularly important for governments to be able to impose requirements on foreign investors to transfer environmentally sound technologies, use local suppliers and participate in joint ventures. Without such links into the domestic economy even the OECD has realised that it is unlikely that FDI will raise domestic environmental standards [27]. However, all these measures breached the list of outlawed performance requirements in the OECD-MAI. The TRIMs agreement also outlaws some similar measures, and some countries may attempt to expand these during its scheduled review in 2000.

Measures which restrict access to land or natural resources according to the number of years someone has resided in a particular place (a common way of defining community rights) were also potentially discriminatory under the OECD-MAI. There was some ambiguity about the legality of such residency requirements, but authorities in the US and some Nordic countries exempted such measures from the MAI to ensure they were not challenged [28].

Though the MAI explicitly included natural resource concessions (mining, forestry, fishing rights etc.) in its description of investment, the provisions tended to treat resources like any other investment. Norway strongly objected to the proposals saying that they conflicted with sovereign resource rights given under UN treaties, especially with regard to hydrocarbon resources [29].

Under the OECD-MAI the sale of all natural resource concessions had to notified in advance to potential investors. It was unclear how this related to the re-allocation of resource rights from the State to local or communal ownership, which is a common part of conservation and development programmes. It was also unclear how post-colonial land reform projects would be carried out given the strict compensation rules in the MAI, especially if the land had been originally taken by force, or through corrupt practices, from their indigenous owners [30].

The OECD-MAI and other investment agreements are based on a naive view that host country environmental regulation is set optimally and enforced perfectly, and so there is no need to promote technology transfer or rising environmental standards. As discussed above, given the economic pressures working against effective regulation, without positive rules to raise standards increasing competition for FDI is likely to chill environmental regulation and promote unsustainable resource use.

The OECD-MAI would have undermined efforts to achieve sustainability by outlawing mandatory requirements for technology transfer, joint ownership and local content. Even though these can be powerful ways of improving the environmental performance of domestic business.

The OECD-MAI conflicted with policies to strengthen local or communal control of natural resources, and reduced the ability of governments to gain fair benefits from natural resources. Any future investment agreements must respect community rights over natural resources, and give sufficient policy flexibility to maximise benefits to host countries.

7. Setting a New Agenda: priorities for international rules on investment

The discussion above leads to several conclusions about the desirability and scope of new international disciplines on investment protection and liberalisation, whether at the WTO or elsewhere:

- Global investment flows are increasing in the absence of any comprehensive framework on investment promotion and protection. Action at the national, bilateral and regional level has created a patchwork of rules which seem adequate for these purposes.

- There is no strong evidence that new rules would increase total global investment flows, or necessarily shift flows to a wider range of host countries. The main determinant of investment flows remains market growth, access to resources and available human and physical infrastructure.

- International business seems to be unenthusiastic about new investment rules, at least in public, unless they provide significant new levels of market access.

- The experience of the OECD-MAI shows the complexity of negotiating broad international investment rules, because they often conflict with national development priorities, including social, cultural and environmental regulations.

- Current systems of policy flexibility for developing countries inside investment agreements do not seem to give adequate scope for countries to follow their development priorities. These areas have received scant attention from OECD countries, and were ignored in the MAI negotiations despite its ambitions to be a multilateral instrument.

Therefore, there seem to be few benefits and many problems in attempting to negotiate a truly international investment agreement in the next few years. Especially at the WTO, where trade access to developed markets can be used as a lever to obtain inappropriate liberalisation concessions from developing countries.

However, there are real and pressing arguments for increased international regulation of investment flows in other areas which have failed to evolve at the same pace as liberalisation. However, the political question remains whether developed countries will be willing to negotiate additional disciplines on international investment outside a comprehensive agreement which also covers investor protection and liberalisation.

Not withstanding the question of political feasibility, WWF considers priority areas for new international regulation to be:

- **Competition policy and restrictive business practices (RBPs)**: increased co-ordination and co-operation to prevent abusive practices, especially by TNCs across borders, could greatly enhance the value of FDI to host countries. However, care must be taken to ensure competition policy is not used as a covert way of forcing market access for TNCs. The existing (non-binding) UNCTAD code on RBPs could be a starting point for discussions.

- **Investor transparency and tax co-operation**: many countries have become more transparent in their rules and procedures for investors, but this has not been not reciprocated. It is often extremely hard to discover who is financing or controlling an incoming investor, which can make screening processes and tax enforcement very difficult. Co-ordinated rules on disclosure of company structures could facilitate higher quality investment decisions, and combined with enhanced taxation co-operation increase collection of revenues from investors.

- **Controls on investment subsidies**: subsidies given to investors - either fiscal or through relaxing environmental or social regulations - are not a primary cause of relocation. However, they do reduce the value of investment to all host countries and distort international investment flows. Developed countries have an advantage as they can give direct cash aid without harming their economy. Meanwhile developing countries have to give up precious tax revenues, or suffer negative environmental or social costs from deregulation. Limits on the amount and circumstances of investment subsidies would therefore improve development prospects in all countries, without reducing overall flows of FDI. The legitimate use of targeted subsidies for development purposes would have to be retained inside any such agreement.

- **Rules on investor responsibility and civil society rights**: high quality investment brings more benefits to host country economies, but in many areas OECD TNCs operate to labour and environmental standards far below those in their home countries. A binding international code of conduct for investors would help prevent such abuses, and would not alter overall investment flows to developing countries. This can be achieved in many different ways; for example, through conditionality on official investment guarantees or by instituting mandatory social and environmental reporting in home countries. The role of local communities and civil society - in both home and host countries - must also be strengthened to deter irresponsible corporate behaviour [31].

- **Promotion of best-practice investors**: investors who make positive efforts to operate to high standards, transfer up-to-date technology and work with local producers and communities should be promoted and rewarded. Such promotion should be allowed under any agreement limiting subsidies, though with safeguards against abuse.

- **Links to programmes to build national regulatory capacity**: official aid flows are being used increasingly to facilitate private investment. To obtain development benefits from such programmes it is important that the regulatory environment in the host country is adequate to avoid corporate abuses, and ensure investment provides social and environmental benefits. There should be an increase in official assistance to build such regulatory capacity, which is directly linked to rising investment flows and commitments under existing or new international investment agreements.

Rules to achieve these ends could be implemented in many different ways: through new international agreements; by changes to existing regional and bilateral treaties; or through complimentary actions in home and host countries. However, to be effective they will have to be co-ordinated to avoid some countries attempting to free-ride on the actions of others, or the competitiveness argument being used as a reason for inaction.

Therefore, an overall strategic approach is needed which identifies appropriate actions at different levels of governance, identifies any existing gaps, and sets timetables and deliverables for implementing agreed common goals (in a similar way to the OECD Bribery Convention).

This strategic task is beyond the competence of the WTO, and must involve many different parts of governments and many existing regional and international institutions. The only forum with the breath of competence to take this work forward is the United Nations system.

Earth Summit III in 2002, and the meetings of the UN General Assembly and Commission for Sustainable Development on trade and investment preceding it, present an opportunity to systematically examine the relationship between investment and sustainable development. This process provides an appropriate, legitimate and existing forum to discuss a broad framework for regulating international investment.

The implementation of such a framework will occur at different levels - multilateral, regional, and national - but the appropriate balance must not be pre-empted by handing negotiations to the WTO.

Instead, all countries - not just the OECD - must have an adequate opportunity to consider their priorities in this area and decide the scope, composition and timing of any new negotiations and related initiatives.

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