

Foreign Investment: Making it Work for Sustainable Development

NEWLY INDEPENDENT STATES WTO/NCSD PROJECT

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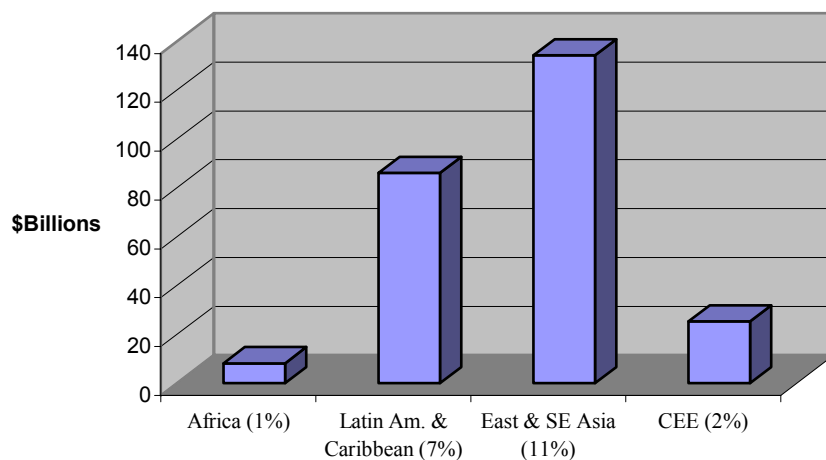
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1. Introduction

Foreign investment is one of the primary engines of development worldwide. Indeed, for those countries with low domestic rates of savings, and poor access to international credit, foreign investment is one of the only vehicles for development of any kind.

Foreign direct investment levels are impressive: in 2000 they reached a record \$1.3 trillion. However, the bulk of that went to developed countries, with developing countries receiving only \$240 billion. Even among the developing countries the allocation was highly skewed, with \$64 billion going to China alone (see Figure 1).

Figure 1: FDI in Selected Regions, 2001



Source: UNCTAD (2001)

The question for many developing countries and economies in transition is how best to attract more foreign direct investment, and how best to ensure that what comes will contribute to sustainable development. These questions are the main subjects of this paper. Before turning to them, the paper begins by setting the terms of the analysis, defining investment and surveying the types of impacts it can have. It then turns to analysis of the factors affecting levels of investment, and to the question how to ensure that investment will contribute to sustainable development. In concluding, it offers a number of policy recommendations based on the preceding analysis.

2. What is Investment?

2.1. Defining investment

There are a number of types of investment, each with very different characteristics. This paper will focus almost exclusively on foreign direct investment (FDI). FDI, along with the other main types of investment, is defined below.

Domestic investment is the lifeblood of most economies. In market economies, almost all small and medium-sized enterprises are supported by investment from resources within the country, whether from banks, the sale of equity or bonds, personal savings or other sources.

FDI is investment by foreigners in productive facilities. This may take the form of the establishment of a completely new facility where none existed before (“greenfields” investment). Or it may consist of an investor purchasing an existing operation through a privatization arrangement, or by way of a merger or acquisition, or starting a new operation on a site that was previously occupied (“brownfields” investment).

Cross-border mergers and acquisitions (M&As) are a growing trend in investment, with growth rates over the last decade that have outstripped rates of growth of investment itself. Not all cross-border M&As are financed by FDI – most are at least partially financed by an exchange of stock between the acquiring and acquired firms. While most cross-border M&A activity has been concentrated in developed countries, where they make up the lion’s share of total foreign direct investment, developing countries and economies in transition are expected to see a rise in cross-border M&As as well, as deregulation and privatization open up new opportunities in sectors such as banking, communications and water services. As a case in point, all of Poland’s large banks are now controlled by foreign banks.

Cross-border M&As are traditionally less welcomed than greenfields FDI by host countries, since they involve investment in an existing facility, rather than in new capital stock or productive capacity. This attitude may be misguided, however. M&As may foster long-term development, if they result in increased efficiency of operation, or if they are followed by new investment in upgrading and expansion. The empirical evidence on this question is mixed.¹

Investment in a country can also occur through the purchase of domestic firms’ shares or bonds by foreigners on the open market. This type of investment – *portfolio investment* – is not foreign direct investment, and will not be the focus of this paper. Most countries have removed controls on portfolio investment. It should be noted that portfolio investment has an undesirable ability to leave a country quickly and *en masse* in the case of investor scares – an ability that can lead to serious short-term problems, as was evidenced in the 1997 Asian crisis where this type of capital flight greatly exacerbated the situation. FDI, on the other hand, is more long-term in its objectives, and is in any case is less mobile.

¹ UNCTAD (1999a), 101 – 103.

2.1. The impacts of investment

The impacts of foreign direct investment on a country are varied and complex, and will differ widely from case to case. This section will survey some of the major ways in which FDI can impact on a host country's development:

- Domestic levels of savings and investment
- Technology transfer and innovation
- The environment and natural resources
- Entrepreneurship and linkages
- Employment and skill development

Savings and investment: The key question here is whether foreign investment "crowds out" domestic investment. That is, for every dollar invested by a foreign investor, if there is less than a dollar's worth of growth of total investment, then the foreign investment has replaced some investment that would have taken place domestically. The FDI may have gone into a sector where there was already a healthy domestic component, and muscled out some existing firms, for example. Or it may be borrowing on the domestic capital market, and raising the cost of borrowing for domestic firms. Given the critical importance of home grown entrepreneurship in the development process, this kind of crowding out can actually make a country worse off for having received foreign investment. On the other hand, it is also possible for investment to "crowd in" domestic investment, by stimulating investment in local firms with which it contracts. Crowding in is most likely to take place where the investment is in a new product or service, not in direct competition with existing firms.

As a rule, mergers and acquisitions tend to have less beneficial effects on savings and investment than do other forms of FDI. But even M&As can crowd in investment, if they are followed by substantial upgrading of the acquired operations.

There is evidence that countries that screen investments by opening up only selected sectors have actually experienced more crowding in than did countries that opened up across the board. One study shows that between 1976 and 1990 the Latin American economies, where liberalization was not restricted, achieved neutral or crowding out effects. In Asia over the same period, where investment liberalization was partial and strategic, there were neutral or crowding in effects.² The type of screening undertaken in the Asian states is administratively demanding, and if not done well may end up scaring off all investment. As well,

² Agosin and Mayer (2000).

the WTO's TRIMS Agreement (discussed below) prohibits many of the most effective measures to achieve it. A pragmatic alternative to prohibiting undesirable investment might be to actively pursue the desirable types.

Technology transfer and innovation: FDI will often involve bringing new technology to the host country. The key question is to what extent that technology has any impacts outside the application for which it was imported. It may be that the new technology requires new types of skills to operate, meaning local staff must be trained. In the long run, this adds to the host country's capacity to undertake its own technological innovation. The same type of capacity building may result just from the presence of a new technology in country, since innovation is built on the foundation of existing ideas and knowledge, and the imported technology adds to that foundation.

Environment and natural resources: FDI may benefit or harm the environment, or both, depending on the circumstances. There is a good deal of evidence that transnational corporations (TNCs) are on the whole "cleaner" in their production practices than are domestic firms. New investments as a whole are generally environmentally better than existing operations. As well, to the extent that investment creates economic growth, and economic growth leads to higher standards, investment may benefit the environment. But this is a tenuous and uncertain chain of causality.

On the other hand, investors may come to a country specifically looking for relatively low pollution control costs. Most analyses of the "pollution haven" hypothesis have failed to turn up much evidence of this effect; pollution control costs are just one of many factors that firms must consider when deciding to site or relocate, and cheap labour costs, for example, may be far more important in the equation. That said, if there is not a strong environmental management regime in place, FDI can have devastating environmental effects. It can mean massive increases in the scale of environmentally damaging operations, in terms of pollution or in terms of depleting renewable resources such as forests or fisheries.

Entrepreneurship and linkages: One of the key questions about a given investment is the degree to which is linked to the domestic economy. Some investments create a number of "backward linkages" - sourcing raw materials, business services and other inputs from local providers. Others may import all their inputs from firms with which they already have established relationships. Obviously the former type of arrangement is more conducive to entrepreneurial development in an economy (and is also easier on the balance of payments). In

an ideal situation, the investor's demands can raise the quality of domestic suppliers to the point where they are internationally competitive. The same sort of dynamic applies in the case of forward linkages – relationships with firms that process, market or distribute the product after the investor has produced it. Backward and forward linkages usually develop over time in the manufacturing and services sectors, but are typically weak in the natural resource sectors (petroleum, mining). Forcing the emergence of linkages through regulation is generally prohibited by investment agreements. The alternative is an active government policy, identifying potential matches between domestic sellers and foreign investor buyers, upgrading the capacity of local firms to meet the needs of investors, and so on.

Apart from the linkages effects, FDI in the service sector – particularly in the communications sector, but also in banking, transportation and insurance – may increase the general competitiveness of the economy, building a more stable platform from which to launch domestic entrepreneurs.³

Employment and skill development: TNCs can make an important contribution to human resource development in host countries, through on-the-job training, hiring of locals to management positions, and so on. But there is still a critical need for government action in this area. For one thing, TNCs are not good at providing for the needs of *future* investments, which may demand more high-tech skills. This kind of foresight is the domain of governments. For another thing, TNCs have specific needs, and cannot be counted on to foster the full range of skills needed by domestic firms, or other investors.

In terms of employment, the manufacturing and services sectors do create substantial employment, though not all of it is of high quality. In the natural resource extraction sector, forestry and plantations can create significant employment. Investment in mining and minerals, on the other hand, being highly capital-intensive, does not create much employment.

Other effects: Foreign direct investment may have other sorts of effects. It may force domestic competitors to increase their efficiency (or it may simply kill off those that are less competitive). It may expose suppliers and competitors to new, innovative management practices that they can incorporate into their own operations. And TNCs will usually bring with them a well-established network of international contacts, opening up new markets for the host country's exports.

³ Note that some service sector industries do not share this characteristic. Tourism, for example, is an important exception.

Charting the impacts of foreign investment on sustainable development is difficult. They can be positive or negative in turn, depending on the host country characteristics and the nature of the investment. But there are a number of policies that can help ensure that any investment delivers results in line with national priorities. Some of these measures are mentioned above, and they are more systematically surveyed in Section 6: Conclusions and Policy Recommendations.

3. What Factors Affect Levels of Foreign Direct Investment?

A number of different factors affect levels of foreign direct investment. This section first breaks down FDI by its various types, according to investor motivation, and then surveys some of the key determining factors: basic investment climate, domestic institutions, and other factors, including infrastructure, labour force, and other considerations.

3.1. The types of FDI

UNCTAD (1999b) notes that there are several types of FDI, in an analysis that is useful background to understanding what factors affect the levels of FDI:

Natural-resource-seeking FDI is the oldest form of developing country FDI. It looks for raw materials, but will also need to find physical infrastructure (ports, roads, power, telecommunications), skilled and unskilled labour. Processing can either be done in country – which presumably yields more development benefits – or abroad.

Market-seeking FDI used to be made in response to import restrictions, but in recent years it tends to be more of a strategic investment. Firms may be looking for access to regionally integrated markets, such as the EU or NAFTA. Or they may be taking advantage of lower transportation costs by manufacturing domestically. Or they may have decided that local demand justifies an investment presence, and may be looking to adapt a global product to domestic tastes.

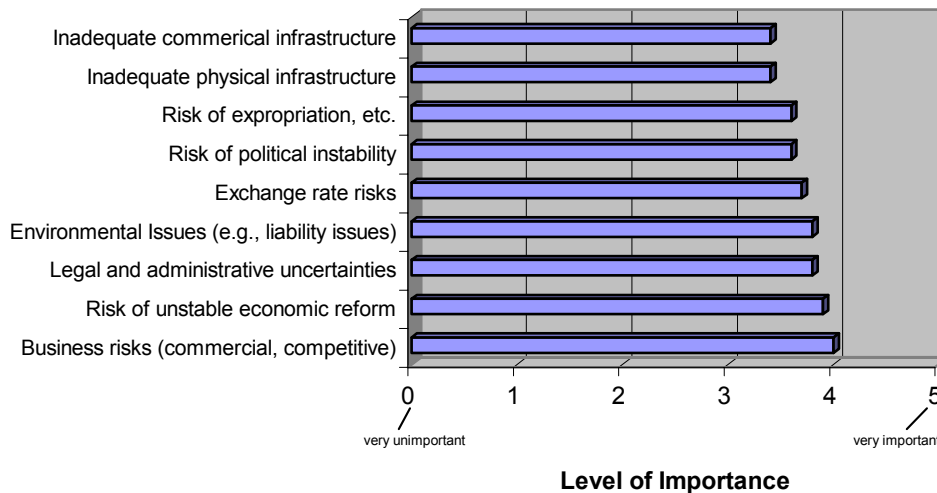
Efficiency-seeking FDI places part of a firm's chain of production in a centre where that aspect can be most profitably carried out. Semiconductor manufacturing – part of the chain of production for computers and other electronic consumer goods – is often located in developing countries, for example, because of cheaper

labour. A new trend in efficiency-seeking is the increase in service sector FDI. For example, many US firms locate their telephone service divisions in English-speaking Caribbean or Asian states, taking advantage of a cheaper educated workforce. And Bangalore, India has become a centre for software development divisions.

3.2. The basic investment climate

At the most basic level, investors are looking for an investor climate that offers stability and predictability over the long term. A survey of FDI in Central and Eastern Europe⁴ asked firms to rank the factors about which they were concerned when making investment decisions. Figure 2 shows the responses. The greatest concern was profitability and competitiveness. A number of factors will affect this calculation – most of them beyond the scope of government policy. They include large markets, natural resources/raw materials and cheap labour.

Figure 2: Importance of Key Impediments to FDI



Source: Klavens & Zamparutti (1995).

The second biggest concern, however, was risks of unstable economic reforms – a factor that is entirely in the realm of government policy. These concerns, in the end, are concerns over macroeconomic problems such as inflation, high interest rates and exchange rate fluctuations, as well as over financial sector reforms, which can affect domestic access to credit. A healthy and stable macroeconomy

⁴ Klavens and Zamparutti (1995).

is an obvious basic factor in determining investment decisions. Risk of political instability is also significant on this list. Of course stability (both political and social) is something that all governments work toward, and not only for its effects on potential investors.

As well, the regulatory environment for investment is important. Are there commitments in place to protect investors against expropriation without compensation, discrimination in favour of domestic competitors, or arbitrary and unfair treatment? Are there restrictions on foreign investors, such as arduous conditions for entry, limitations on repatriation of profits, requirements to purchase domestic inputs, or requirements to export a certain percentage of output? Are there restrictions on foreign currency conversion? The nature of the domestic tax regime is also a major consideration for potential investors. Is it overly onerous? Overly complex? Unfriendly to foreign investors?

3.3. Strong domestic institutions

Beyond the basic investment climate, there are a number of domestic institutions whose integrity will affect investment decisions. These are a key part of the web of support that investors will need to effectively carry on business in a country.

As the survey results cited above show clearly, one of the key institutions of this type is the regime for environmental management.⁵ Primarily the concerns here relate to the liability that investors may face if properties they acquire turn out to be contaminated by previous owners. But they also relate to uncertainty over future liability for their own practices, and to uncertainty about future and existing environmental standards. These types of concerns can only be addressed by establishing a fair and transparent regime for liability, as part of a broader effort to establish a sound and predictable environmental management regime.

Legal and administrative institutions are also important. While some recent work shows that most investors are realistic about their expectations for a fully functional justice system⁶ – understanding that such a thing takes many years – the more predictable and reliable the system can be, the better. Contract law and standard accounting and reporting practices are an important part of this system.

⁵ The group of survey respondents with actual investment experience in CEE ranked environmental issues as highly as the top-rated concern in the survey as a whole, scoring it 4 out of 5.

⁶ See Hewko (2002).

Administrative concerns relate to bureaucratic procedures such as approvals and licensing, and the integrity of the civil service. Ideally, any procedures that investors must follow should be uncomplicated and clearly established, with details easily available.

3.4. Other influencing factors

Beyond the basic investment climate and strong domestic institutions, there are other factors that will have positive effects on investment decisions. Key among these is the state of domestic infrastructure. The transportation system is clearly important, inasmuch as it will be needed for getting inputs to the firm, and getting the firm's products to their markets.

An efficient communications system is also important. Primary industries account for an increasingly small share of industrial production, replaced by services and knowledge-based industries, both of which demand solid communications infrastructure. And even labour-intensive production is increasingly performed as a part of an international production chain that is held together by strong communications links.

The quality of the labour force is also a key factor for many of the new industries, with strong basic education and specific job-related skills being important.

Firms may also look for opportunities to locate in "clusters" with other related firms, looking for synergies in proximity. These types of clusters may be constituted of firms of the same type – for example, software developers – and/or of firms at different stages of specific production chains, whose proximity allows for increased efficiencies.

Finally, foreign investors will take into account the types of national-level institutional support that exists for them. Is there a specific national body charged with attracting FDI and meeting the needs of existing operations – a single body to which they can go with their concerns or questions? Are there government incentives for investment, or expenditures on supporting initiatives such as relevant research and development?

4. Attracting FDI: Policy Options

The 2001 World Investment Report describes something like an evolution of investment-friendly policies, describing three generations of policies.⁷ The **first generation** is the adoption of market-friendly policies: countries “liberalize their FDI regimes by reducing barriers to inward FDI, strengthening standards of treatment for foreign investors and giving a greater role to market forces in resource allocation.” A step beyond these basic policies is the kind of institution building discussed above: strengthening environmental management and the rule of law, for example.

The **second generation** of policies sees governments actively seeking FDI by marketing themselves as destinations for investment. This is usually done through investment in appropriate infrastructure and human resources, and the establishment of national investment promotion authorities – bodies that are usually also mandated to focus on the unfinished business of the first-generation policies.

The **third generation** of policies becomes strategic in the pursuit of FDI, usually pursuing specific types of investment at the firm or industry level, or looking for “clusters” of symbiotic investments, in line with national or regional strengths and development priorities. Note that these three “waves” of policies should not be thought of as sequential. That is, the analysis above should have made it clear that ideally all of these types of policies would be pursued simultaneously, though that may be a tall order for many resource-strapped governments.

The types of policies involved can be grouped into those that aim to attract investment – described above and in the previous section: policies to improve the basic investment climate, policies to strengthen domestic institutions and the second and third generation “marketing” policies – and those that aim to ensure that any investment that does come will contribute to economic, social and environmental progress. The latter group of policies will be discussed in section 5, below. The rest of this section will focus on policies for improving the basic investment climate, and specifically on those aimed at improving the regulatory environment.

4.1. Improving the regulatory environment

Many countries have undertaken to write national investment laws to provide a predictable framework for incoming investors, or they have unilaterally

⁷ UNCTAD (2001).

liberalized in ways that may make them more attractive to foreign investors. They may, for example, remove requirements for a certain percentage of domestic ownership, or loosen permitting procedures for foreign investment. They may remove requirements for import permits or licences, making it easier for investors to import foreign-made inputs. They may remove controls on currency trading, or restrictions on repatriation of investors' profits. These types of liberalization measures may be taken as part of a national strategy to attract investment, or may be undertaken at the insistence of lenders such as the World Bank or the IMF as part of structural adjustment plans.

Many countries have complemented these domestic efforts with efforts to negotiate international treaties governing investment. These international agreements come with certain costs that are analyzed in greater detail below, using the Energy Charter Treaty as a case study. The most frequently-used international agreements are the relevant WTO Agreements (TRIMs and GATS), bilateral investment treaties (BITs), regional agreements, and sectoral investment treaties (for example, the Energy Charter Treaty). Each of these is briefly described below.

TRIMs: The Agreement on Trade-Related Investment Measures is part of the WTO body of law, and all WTO Members are obliged to abide by its obligations. The essence of the agreement is a list of measures that Members agree not to take. For example, TRIMs prohibits:

- Measures that specify the level of domestic inputs a foreign investor must use.
- Measures that limit the amount a foreign investor may import or export.
- Measures that limit a foreign investor's access to foreign exchange.

The principles that frame this list of measures are *national treatment* – that foreign investors should be treated no worse than domestic ones, in like circumstances – and *no quantitative restrictions* – that there should be no measures restricting the quantity of imports or exports. WTO negotiations on investment under the Doha round are aiming to broaden the agreement to also address other types of measures, such as expropriation and measures tantamount to expropriation. The agreement applies only to investment measures that distort or restrict international trade, such as those cited above.

GATS: The General Agreement on Trade in Services is another part of the WTO that all Members must abide by. While the TRIMs Agreement covers foreign investment for the production of goods, the GATS Agreement covers any foreign

investment made in the service sector: banking, insurance, real estate, tourism, transportation, communications, business services, health care services and so on.⁸

However, whereas the TRIMs Agreement applies to *all* measures affecting trade-related investment, the GATS Agreement only covers those sectors in which Members have explicitly agreed to bind themselves. The Doha Round of WTO negotiations (due to end by 2005) will clarify which sectors the individual Members will offer, and the exact nature of the disciplines they will be bound by. These will include commitments related to process – transparency of regulations, for example – and more substantive provisions, such as prohibitions on certain types of measures – for example, measures limiting the total number of service providers, or the size of the sector, and measures limiting the size of the foreign participation in the sector.

BITs: There are some 2,000 Bilateral Investment Treaties in existence. These are signed between two nations who agree to accord certain types of treatment to each other's investors; most are agreements between a developed and a developing country. Each agreement is unique, but most contain the same types of provisions. Typically they will:

- Prohibit expropriation, unless for a valid public purpose and unless accompanied by compensation.
- Prohibit “performance requirements,” such as requirements to export certain amounts of output, or to purchase local inputs, or to transfer technologies on particular terms.
- Demand national treatment and most-favoured nation treatment.
- Demand some sort of minimum standards of treatment for foreign investors.

The typical BIT also sets up a system of arbitration that allows the investor to initiate proceedings over alleged breaches of state obligations. The treaties usually specify a particular legal forum (from the several that exist at the international level) under the rules of which a complainant can have its case heard.

⁸ GATS also covers other forms of trade in services, such as services provided directly from the host country, with no commercial presence – and therefore no investment – in the receiving country. Note that neither GATS nor TRIMs covers measures related to government procurement of goods and services.

Regional Agreements: Several regional trade agreements also include provisions concerning investment. These range from the highly detailed, institutionally elaborate provisions contained in the EU Treaties to the relatively modest provisions of the Mercosur Treaty system. The investment provisions of NAFTA, closely modelled on BITs provisions, have become very controversial.⁹

Sectoral Agreements: There are also a small number of sectoral agreements on investment. The Energy Charter Treaty, for example, binds signatories to certain kinds of treatment of each other's investors in the energy sector. This treaty is discussed in greater detail below.

While some larger economies may be able to attract FDI without making their regulatory environments particularly investor-friendly, for most others an attractive regulatory environment will be a necessary ingredient in the recipe to attract investment. That said, two caveats should be raised. The first is that such an environment by itself is not enough to guarantee an inflow of FDI. Particularly as the majority of countries adopt investment-friendly reforms, it will take more to distinguish potential host countries as desirable, including policies to ensure basic social and economic integrity and stability, strong domestic legal and regulatory institutions and, increasingly, even a strategic pursuit of investors.

In other words, successfully attracting FDI involves a great deal more than penning an investment liberalization agreement. In fact, Mallampally & Sauvart (1999) argue that "With liberal policy frameworks becoming commonplace and losing some of their traditional power to attract FDI, governments are paying more attention to measures that actively facilitate it." Most countries in the world have acceded to the WTO, and are signing BITs with host countries of major FDI flows. With the playing field more or less level as concerns liberalization, investors are looking at other factors as determinants of their investment decisions.

The second caveat is that international investment agreements, while they may be regarded as a basic prerequisite to attracting investment flows, may also constrain domestic policy options in some important ways. Some of these are intentional, as with the WTO's prohibition on certain measures relating to trade-related investment.

⁹ See Mann (2001), Mann and von Molke (2002).

But others seem to be completely unintentional. There is a growing concern that the substantive provisions in most BITs, while originally intended to serve as protection against egregious government behaviour, are now serving as the basis to scrutinize government regulations and regulatory processes, holding them in judgement in ways not intended by the drafters.¹⁰

A case study of the Energy Charter Treaty follows. It sounds a warning about the ways such investment agreements are increasingly being used – with specific reference to developments in the context of the North American Free Trade Agreement (NAFTA) – and the kinds of impacts this may have on government policy.

4.1.1. Case study: the Energy Charter Treaty

The Energy Charter Treaty is a multilateral trade and investment treaty designed to facilitate private sector involvement and investment in the energy sector of the economies of the former Soviet Union. The treaty entered into force in 1998 and as of August 2002, has been ratified by 46 countries from Western and Eastern Europe, western Asia and Japan.

Investment liberalization and protection is one of the four main pillars of the ECT (the others being trade, transit and environment/efficiency). The ECT's investment rights closely mirror those in other modern investment treaties (see above). The treaty offers investors the better of national treatment and most-favored nation treatment, as well as guarantees against expropriation without compensation, and provisions allowing for transfers of key personnel and money. The ECT's non-discrimination guarantees are applicable to investments post-establishment – i.e., once an investment has been made in a host state. A supplementary treaty, which has been under negotiation over a period of several years, will see the treaty's coverage extended to the “whole investment cycle” i.e. including rights of entry for new investors.¹¹

Because these investment rights are closely modeled upon similar rights in bilateral and regional investment treaties, they also share many of the same shortcomings; most notably, the rights tend to be broadly couched or even vague in their articulation. Thus, the actual substance of these rights will need to be

¹⁰ See Mann (2001).

¹¹ Craig S. Bamberger, Jan Linehan, and Thomas Waelde, “Energy Charter Treaty in 2000: in a new phase”. *Journal of Energy & Natural Resources Law* Vol. 18, No.4, 2000, 345-6

fleshed out through the resolution of disputes which may arise and will be arbitrated under the treaty's dispute settlement clauses (Articles 26 and 27).

Most worryingly, the ECT's investment provisions closely parallel those in the North American Free Trade Agreement (NAFTA). These NAFTA rights have attracted considerable controversy as a result of their invocation in an unanticipated array of disputes between investors and host states targeting health and environmental regulation.¹²

Recent cases under the NAFTA's investor-state dispute resolution process have involved complaints from investors over government policy measures in the areas of hazardous waste management, regulation of toxic substances, government provision of postal services, natural resource export management, and other issues of broad public policy. In some of the most troubling cases, firms have argued successfully that the measures in question amounted to an expropriation of their investment, and won tens of millions of dollars as settlement. The most troubling aspect of these cases is the lack of balance: the measures are judged on commercial grounds only, without taking into account other legitimate objectives of governments, such as environment, health, public order and so on. Contracting Parties to the Energy Charter Treaty – even if they do not yet have sophisticated regulatory regimes that might be challenged – should pay heed to the NAFTA developments.

The *process* of investor-state arbitration used in treaties like the ECT, NAFTA and most BITs is not suited to the resolution of sensitive public policy disputes. Because these arbitrations use existing forms of international arbitration (most of which have been designed for commercial disputes, typically between two private parties) these arbitrations occur behind closed doors, usually without much public notice and with insufficient opportunity for participation by interested parties and the public. In particular, the UNCITRAL and Stockholm Chamber of Commerce arbitration rules make no requirement that disputes be publicized in any manner. Indeed, disputes may be lodged by an investor against a host state without even a need to notify the permanent Secretariat of the Energy Charter Treaty. The lack of channels for public input mean that important arguments based on environmental, development or human rights grounds may not be presented. Such closed proceedings work well enough in purely commercial disputes, but modern disputes can center on issues of broad public interest, as seen in the examples from the NAFTA setting. As such, they

¹² See Mann (2001), Mann and von Molkte (2002).

should be conducted with a greater degree of legitimacy, accountability and transparency than at present.

Although formal arbitrations have emerged under the ECT's dispute settlement provisions, there is little publicly available information about these disputes. Experts concede that the ECT is also used informally by investors to challenge proposed or actual host state measures.

5. Ensuring that Investment Fosters Sustainable Development

We should begin answering this question by defining what we mean by sustainable development. The definition used by the World Commission on Environment and Development (often referred to as the Brundtland Commission) widely credited with coining the term is: "development that meets the needs of the present without compromising the ability of future generations to meet their needs."¹³ Its foundation is the belief that environmental, economic and social progress are linked, such that in the long run none can be pursued at the expense of the others – all must be achieved together. The question is, then: how can governments best ensure that the investment they attract will contribute to economic, environmental and social progress?

At a general level, the challenge is to have policies and institutions in place that will screen out undesirable investments, and will ensure that the benefits from those that do come are tangible and well distributed. A number of those policies and institutions were discussed above, and the following section summarizes the policies that might contribute to their establishment. This section briefly summarizes the types of considerations that will guide government action in this area.

Policies designed to attract FDI will generally help to foster economic progress. At a more specific level, the analysis in section 2.1 suggests a number of potential measures for wringing the greatest possible economic benefits out of that investment. These include screening of investments to favour certain sectors (though most forms of this are prohibited by typical investment agreements), investment in upgrading labour force skills, and in basic education, investment in the capacity of local firms to foster greater linkages to foreign-owned firms, and ensuring that foreign-owned firms do not choke out local firms by competing for domestic credit.

¹³ WCED (1987).

Social progress can be pursued by a variety of measures, the final choices depending on each country's specific circumstances. Some obvious types of measures likely to be relevant to a wide range of countries include: strong laws and enforcement capacity on occupational health and safety, and fair labour practices. Also needed will be programs of support and retraining for those whose livelihoods are disrupted by the liberalization process.

It was noted above that without a strong regime for environmental protection, it is possible that new investment may greatly exacerbate a country's environmental problems. There is a wealth of documented evidence that increased scale of activity in sensitive sectors, brought on by trade and investment liberalization, can bring about enough pollution and resource depletion to significantly lower the public welfare. A strong environmental regime is an important prerequisite to having investment contribute to sustainable development, and the following section gives some guidance on the desirable elements of such a regime.

6. Conclusions and Policy Recommendations

This paper has surveyed two broad classes of policy action that countries can take to attract the right kind of investment and manage it well. One is a set of actions to be pursued at the domestic level, and the other will take place at the international level.

6.1. Domestic level actions

There is a whole class of government actions that are outside the scope of this paper – intended to secure social, political and economic stability. It was noted that this stability is the bedrock of a good investment climate.

Evidence suggests that there is some value to screening potential investments for those most likely to contribute to national development goals. This may foster more crowding in of domestic investment. But, as mentioned, the most effective tools for screening are prohibited by international investment treaties.

A more passive approach to fostering linkages can also be pursued. This might consist of actively working to upgrade the capacity of domestic suppliers, and to match them with buyers among foreign affiliate firms.

Another element of a good investment climate is investor certainty of fair treatment – freedom from expropriation, guarantees of national treatment, and

so on. These types of commitments can be built into national investment legislation. More proactively, countries can also dismantle, or commit to not using, performance requirements such as requirements to transfer particular technologies, requirements to export certain percentages of output, requirements that investors purchase local inputs, etc. The more restrictive the demands a country places on an investor, the less attractive it is as a destination.

As well, there are a number of ways governments can strengthen domestic institutions to better attract investment, and to ensure that it contributes to sustainable development. A solid environmental management regime is an important prerequisite. An environmental impact assessment process should help screen out or re-work potentially damaging investments. There should be clear regulations governing emissions and managing exhaustible resources such as fisheries and forestry, as well as the capacity to enforce those laws. A state-of-environment reporting system should help monitor environmental trends to pick up any unexpected impacts. There should be clear legal liability provisions so that investors know exactly where they stand in making *brownfields* investments.

Another important area of law is occupational health and safety. This is important to help ensure that new investment actually results in good quality employment.

The legal system more broadly is another key institution that may need strengthening. There should be standardized rules of accounting and corporate reporting. Contract law needs to be in place. And there must be a functioning judiciary to adjudicate the inevitable disputes.

Administrative systems are also important. Rules relating to investors and businesses in general should be transparent and simple. Permitting and licensing should not be too slow or too complex.

Several types of infrastructure may be worth upgrading to help attract investment. Communications is clearly one – a functioning phone system is a basic prerequisite, and available use of the Internet may be useful. Transportation is another – investors need routes by which inputs can reach them, and by which they can ship their products, both domestically and internationally.

Government investment in human resource development may also be beneficial in attracting and keeping investment. Ensuring widespread basic education is a

good first step. Governments might also try to forecast the emerging needs of investors, and undertake training specific to those needs.

The impacts of liberalization are sometimes painful as old, inefficient, industries are replaced by newer ones. There should be programs in place to help ease the pain of transition, such as programs to retrain the unemployed, or to support them through the period of transition.

In some cases, governments may want to shelter “infant” domestic industries from the full force of foreign competition, giving them the time they need to become more competitive. There are some provisions for these types of measures in developing countries under WTO rules (see discussion below).

Many governments have established bodies charged with attracting foreign direct investment, and with meeting the needs of existing investors. These then become a channel through which investors can communicate their needs and concerns to governments, as well as a force for reform in and of themselves. These may also be used as tools to strategically pursue the types of industries most in line with a chosen development path.

6.2. International Actions

In parallel to the actions taken at the domestic level, there are a number of actions that countries might take at the international level to help attract investment. These are solely focused on getting investment to come, and have little to do with assuring the quality of the investment, or of helping ensure that it fosters sustainable development in country. All of the options surveyed below involve signing some sort of international treaty committing to certain types of treatment for investors.

An expansion of the TRIMs Agreement, discussed in section 4, is currently under negotiation in the WTO as part of the Doha Round of negotiations. If it goes forward (there is some uncertainty still about its final fate) it looks likely to be significantly expanded and strengthened. There are several issues that developing countries may want to pursue in these negotiations, based on the analysis above.

First, it is worth asking whether it is in their interests to have such a negotiation take place at all. Some developing countries, India being prime among them, are claiming that even the existing TRIMs Agreement is too restrictive of its policy actions to promote development. They will have an opportunity to stop the

negotiations cold, should they so choose, at the next WTO Ministerial meeting in September 2003.

Second, if negotiations do proceed, there are some noteworthy key areas. One is the scope of the agreement, with some countries arguing that it should go more broadly than protecting FDI, to also include portfolio and other non-productive forms of investment¹⁴. It was noted above that the liberalization of such investment presented special challenges for governments, because its extreme mobility could exacerbate economic downswings. It may not be in the interests of countries with weak capital markets to sign up to anything that causes them to quickly liberalize this kind of capital flow.

Third, it was noted above that there may be scope for developing countries under the existing agreement to temporarily protect what are called “infant industries.” It will be important to watch that this kind of policy space is not eroded in the negotiations.

This paper also surveyed a number of other types of international investment treaties, including BITs, regional agreements and sectoral agreements. All are often touted as key to attracting FDI. From the analysis above we can draw several recommendations on this subject. First, it is clear that signing such agreements is only a very small part of any complete effort to attract foreign direct investment, and to ensure that it serves sustainable development. Indeed, the evidence is not great on the actual effectiveness of such agreements by themselves in attracting investment.

Second, given the types of concerns raised from the NAFTA and ECT context, countries may want to wait until the full legal implications of such treaties are clearer before signing. In both the NAFTA and the BITs, it will be a few years before we have enough case law to begin to understand the answers to some fundamental questions: Under what circumstances can regulations be considered expropriation? What does national treatment actually mean in the context of investment? Until such issues are clearer, signing these types of agreements has uncertain impacts on the ability of governments to regulate in the public interest, and may expose governments to costly unexpected litigation.

¹⁴ See International Trade Daily, September 19, 2002, “U.S. Plan to Include Portfolio Investment In Doha Round Gets Frosty WTO Reception”

That said, the alternative to international agreements on investment is domestic law that guarantees the same types of treatment: freedom from expropriation, national treatment, freedom from performance requirements. It should be noted that domestic level commitments of this type will be seen by foreign investors as less reassuring than will commitments in international law.

Taken together, the avenues for domestic and international action comprise a full agenda. While no country can hope to excel in all these areas, any country that hopes to attract FDI should at least make conscious choices about the tools and initiatives it will use, and the results it hopes to achieve, with a long term strategy to make FDI work for sustainable development.

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