

Policy pointers

'Pre-establishment' obligations in IITs can significantly reduce a government's control over what foreign investment it admits, and can reduce flexibility for future investment policy.

The central issue here is not whether a state should liberalise investment flows: rather it is recognising the implications of using IITs to do so.

Before entering into binding commitments on the admission of foreign investment, governments should fully appreciate the ramifications, including how commitments in a newly negotiated treaty may be claimed by investors covered by other treaties, and vice versa.

Where states wish to include pre-establishment obligations in an IIT, different ways to define or exclude sectors and measures to be covered can make a real difference to how much national control is preserved. These choices require careful consideration.

Investment treaties and sustainable development: investment liberalisation

States wishing to regulate the conditions under which they admit foreign investment generally use national law. But many international investment treaties (IITs) include provisions to liberalise investment flows. Investors may value these 'pre-establishment' provisions. But pre-establishment treaties can also significantly affect the ability of states to regulate admission conditions for foreign investors wanting to operate in their jurisdiction. This briefing is the second of four promoting debate on IITs and sustainable development.

Under international law, states have the sovereign right to regulate what foreign investment is admitted to their territory, and define terms for admission. Admission policy usually depends largely on national law, as most international investment treaties (IITs) concern themselves with how foreign investment is treated once it has entered the host state's territory.

But IITs following a 'pre-establishment' model do create obligations to admit foreign investment under certain conditions. These treaties require governments not to discriminate against the investors from the other state party when admitting investment.

This pre-establishment approach is particularly common in the treaties concluded by Canada, Japan and the United States and their partners, while IITs led by European countries tend not to feature such provisions. Pre-establishment provisions are also common in treaties that protect investment as part of wider preferential trade and investment agreements.

Such pre-establishment provisions can have important consequences for a country's ability to

regulate its admission policy. So their inclusion in an IIT, and their formulation, require careful consideration and debate.

How pre-establishment models work

The specific wording of pre-establishment obligations varies from treaty to treaty. But pre-establishment IITs usually provide that, when it comes to establishing, acquiring or expanding investments, the host state must treat covered foreign investors no less favourably than its own nationals ('national treatment') and/or nationals of other states ('most-favoured-nation' treatment).

The national treatment standard means that making foreign investments is, in principle, subject to the same rules and procedures applicable to investments by nationals. It also means that foreign investors can, in principle, acquire the same rights as nationals (to land or to companies, for example), and exercise the same economic activities.

This does not constitute, in itself, full liberalisation of investment flows. Government authorisations

Pre-establishment obligations can significantly reduce a government's control over foreign investment flows

may still be a pre-condition for investment if they are applied to both nationals and non-nationals in a non-discriminatory way. But pre-establishment obligations do restrict options for national policy, because states cannot in principle prevent foreign investors from undertaking certain

economic activities, or exclude them from rights available to local nationals.

IITs do usually circumscribe the scope of pre-establishment obligations in several ways. For example,

some IITs only apply pre-establishment obligations to sectors or measures that are specifically mentioned in the treaty, or in schedules attached to it. This approach is generally referred to as 'positive listing'.

Other IITs frame pre-establishment obligations in general terms, but also identify reservations for specified sectors or activities ('negative listing'). In these cases, pre-establishment obligations apply to all sectors and measures that are not explicitly listed.

In addition, pre-establishment IITs typically identify exceptions for measures relating to covered sectors and activities that do not conform to IIT requirements and that states wish to preserve. The treaty may even exempt all existing non-conforming measures, so that pre-establishment obligations effectively only apply to new measures.

Considering the policy trade-offs

Some governments may be prepared to agree to limit how they exercise their sovereign powers in future, in order to attract investment. But it is important not to underestimate how pre-establishment provisions in international treaties can erode the host state's ability to regulate the admission of foreign investment into its territory without incurring into liabilities.

The issue discussed here is not whether a state should liberalise investment flows or not. Rather, it is whether a state that wishes to liberalise investment should do this through IITs.¹ States can and often do liberalise investment by reforming national law. Should there be a policy change in future, a state can more easily change its own national law than renegotiate or terminate an investment treaty — not least due to the restrictions on termination contained in many IITs (see the related overview briefing).

In other words, enshrining liberalisation commitments in an IIT tends to make a country's investment policy more rigid. In return, a country may obtain significant benefits in terms of access to investment opportunities in the other states parties to the IIT. Treaties are usually formulated in reciprocal terms.

But when a low-income country negotiates an IIT with a high-income country, the economic reality, at least in the short term, may well be that investment flows in one direction only — from the high-income country to the low-income country. In these cases, the real benefits of treaty-based reciprocal investment liberalisation for the low-income country are less clear.

Treaties that follow a 'negative listing' approach are particularly delicate to negotiate. The treaty, or schedules annexed to it, must explicitly cover all measures and sectors that a state would like to exempt from pre-establishment obligations. Failure to do this may force the state to change its own legislation in order to comply with the IIT — or expose the state to investor claims.

Getting the list of exclusions right can be complex. Some IITs between high and low-income countries present significant asymmetries in the scope of exceptions and reservations: the richer country, which may have negotiated many more IITs and developed considerable experience with treaty negotiation, may be able to negotiate a comprehensive and sophisticated schedule of exceptions and reservations; while the poorer country may have a shorter, more basic schedule, and end up leaving important national policies vulnerable to challenge.

It is worth noting that pre-establishment obligations are not the only way to reassure investors about the way they will be treated at the admission stage. States can also make less intrusive commitments. For example, a treaty provision stating that investments must be admitted in accordance with the national laws of the host state would preserve that state's ability to impose entry controls and change laws over time. And it would also protect investors against arbitrary government decisions that conflict with national law.²

Performance requirements

In addition to prohibiting discrimination in the admission of foreign investment, some IITs also restrict the use of performance requirements.

Performance requirements are "stipulations, imposed on investors, requiring them to meet certain specified goals with respect to their

operations in the host country”.³ They are typically imposed because host countries want to maximise their economic benefits from investments. Performance requirements may be established through sector-specific legislation, such as that regulating the oil and gas sector; investment legislation; or contracts between the investor and the government.

Performance requirements can cover a wide range of issues linked to a company's operations — from 'local content' requirements for the company to source specified percentages of goods and services from local businesses, through to requirements linked to employment creation, exports, technology transfer or research and development. They can be used as a condition for the admission of foreign investment, or during its operation.

Both developed and developing countries have made extensive use of performance requirements yet evidence on their effectiveness is mixed.³⁻⁵ Some evidence suggests that performance requirements have effectively increased countries' export orientation, for example in Brazil, Chile, Japan, Malaysia, Thailand and the United States. On the other hand, performance requirements on local content or research and development tend to have little effect unless there is adequate local capacity to take up the business opportunities created.

Some commentators also argue that performance requirements may lead to inefficiencies due to their inherently 'protectionist' nature.⁵ Making local businesses more efficient and competitive is crucial for promoting positive economic linkages, whether performance requirements are used or not.

Most investment treaties do not contain provisions restricting performance requirements — but some do. This is particularly common in investment treaties that take a pre-establishment approach, in other words in those that create host state obligations on admitting foreign investment.

The use of some types of performance requirements is already restricted under the rules of the World Trade Organization (WTO). The WTO Agreement on Trade-Related Investment Measures (TRIMs Agreement) prohibits measures that are inconsistent with state commitments not to discriminate against non-nationals in trade in goods, and with state commitments to remove quantitative restrictions on imports of goods. So 'local content' requirements are prohibited. The vast majority of

countries are now members of the WTO and are bound by these provisions, although least developed countries have benefited from special transitional periods.

But where IITs restrict use of performance requirements, they often involve much more wide-ranging constraints than those imposed by WTO norms. For example, some IITs restrict performance requirements concerning employment or research and development, which are outside the scope of the WTO TRIMs Agreement.

Also, remedies for violations differ between the WTO and investment treaties. The WTO focuses on disputes between states: a challenge to a prohibited performance requirement would need to be brought by the investor's home state. In practice, this state may not want to bring a dispute against a host state, based on multiple considerations, including political ones.

In contrast, most IITs give investors direct access to international remedies through investor-state arbitration (see the briefing on investor-state arbitration). There is a small but growing number of awards where arbitral tribunals have found that performance requirements violated an investment treaty,⁶ and also where they found the disputed measure not to violate a treaty commitment.⁷

As with wider investment liberalisation issues, the point here is not whether or not states should introduce performance requirements. Rather, it is whether and to what extent it makes sense to regulate performance requirements through IIT provisions, as these then restrict policy options. In other words, the issue is about acceptable levels of restriction on national policy space.

Interface with regional treaties

As with investment protection (see the related briefing on investment protection), most-favoured-nation clauses in IITs, discussed above, can indirectly impose tighter restrictions on admission policy than a host state intended. This is because such clauses require the host state to treat foreign investors or investments no less favourably than investments in similar circumstances by nationals of other states.

So, for example, an investor covered by an IIT with a most-favoured-nation clause may be able to claim 'pre-establishment' national treatment in a wider range of sectors and measures, or tighter restrictions on performance requirements, if these are provided for in another IIT signed by the state in which the investor operates.

This issue is particularly important if one considers the interface that may exist between an IIT and a regional integration agreement that promotes investment liberalisation. For example, the Association of Southeast Asian Nations (ASEAN) Comprehensive Investment Agreement (ACIA) liberalises investment in specified but broadly defined sectors (manufacturing for example), subject to each country's schedule of exceptions and reservations.

ACIA also restricts performance requirements, but only through referring to the WTO TRIMs Agreement. In other words, ACIA does not restrict many types of performance requirements, for instance concerning employment or sourcing of services.

But if an ASEAN member concludes an IIT with a non-ASEAN state, and this treaty provides more advantageous treatment for investors than through ACIA — for instance through more far-reaching application of national treatment or through more stringent restrictions on performance requirements — ASEAN investors might argue that the ACIA most-favoured-nation clause entitles them to the more favourable treatment too. In other words, ASEAN investors might argue that they should be exempted from measures put in place by the government even though these were not restricted by ACIA.⁸

Effectively, this would mean that, unless the treaties are properly thought through, an ASEAN member negotiating with a third country could be providing benefits to all ASEAN members without getting much in return.

Conclusion

Before signing up to pre-establishment obligations in investment treaties, it is important to carefully consider their full implications and the range of possible alternatives. Pre-establishment obligations can significantly reduce a government's control over the admission of foreign investment, and increase rigidity in investment policy.

It is also important for governments to fully appreciate the ramifications that pre-establishment commitments can have, including through the operation of most-favoured-nation clauses and the interface with regional integration agreements.

Where states wish to include pre-establishment obligations in an IIT, different approaches to framing the treaty (positive or negative listing, for example) can make a difference to the preservation of policy space.

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This briefing is part of a set of four aimed at promoting debate on investment treaties and sustainable development. Other briefings in the set cover the following topics:

Overview: <http://pubs.iied.org/17238IIED>

Investment protection: <http://pubs.iied.org/17240IIED>

Investor-state arbitration: <http://pubs.iied.org/17241IIED>

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Notes

¹ This distinction is articulated clearly in the commentary accompanying the Southern African Development Community (SADC) Model BIT Template 2012, <http://www.iisd.org/itn/wp-content/uploads/2012/10/SADC-Model-BIT-Template-Final.pdf> / ² United Nations Conference on Trade and Development (2012) Investment Policy Framework for Sustainable Development. http://unctad.org/en/PublicationsLibrary/webdiaepcb2012d6_en.pdf / ³ UNCTAD (2003) Foreign direct investment and performance requirements: new evidence from selected countries. http://unctad.org/en/Docs/iteia20037_en.pdf / ⁴ Beviglia Zampetti, A and Fredriksson, T (2003) The development dimension of investment negotiations in the WTO: challenges and opportunities. *Journal of World Investment* (4) 3 399–450. / ⁵ Moran, TH (2011) Enhancing the contribution of FDI to development: a new agenda for the corporate social responsibility community, international labour and civil society, aid donors and multilateral financial institutions. *Transnational Corporations* 20(1) 76–78 / ⁶ Mobil Investments Canada Inc. and Murphy Oil Corporation v. Government of Canada. Decision on liability and on principles of quantum. 22 May 2012, ICSID Case No. ARB(AF)/07/4, <http://www.italaw.com/cases/1225> / ⁷ ADF Group Inc. v. United States of America. Award. 9 January 2003, ICSID Case No. ARB(AF)/00/1, http://italaw.com/documents/ADF-award_000.pdf / ⁸ Because ACIA excludes pre-establishment obligations from investor-state arbitration, this claim might be more difficult to enforce.