THE DEVELOPMENT IMPLICATIONS

OF THE

MULTILATERAL AGREEMENT ON INVESTMENT

A report commissioned by the Department for International Development

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LIST OF ABBREVIATIONS:

APEC	Asia-Pacific Economic Co-operation
DAC	Development Assistance Committee
DfID	Department for International Development
DSU	Dispute Settlement Understanding
FDI	foreign direct investment
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
ICSID	International Centre for the Settlement of Investment Disputes
ILO	International Labour Organisation
IMF	International Monetary Fund
LDCs	less developed countries
LICs	low income countries
MAI	Multilateral Agreement on Investment
MFN	most favoured nation treatment
MICs	middle income countries
MNC	multinational corporation
NAFTA	North American Free Trade Area
NGO	Non-Governmental Organisation
NT	national treatment
OECD	Organisation for Economic Co-operation and Development
TRIMs	Trade-Related Investment Measures
TRIPs	Trade-Related Intellectual Property
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade, Aid and Development
WTO	World Trade Organisation

EXECUTIVE SUMMARY

Developing countries stand to gain from membership of a multilateral investment agreement. In a global economy, this is the best way to encourage the long-term productive capital formation by foreign and domestic firms that will support sustainable development.

By committing themselves to an international regulatory regime, developing countries would achieve a substantial reduction in investor uncertainty, which should lead to more and better investment by foreign, domestic and expatriate firms. Additional benefits can be expected from the control of activities such as corrupt concessions, money laundering and tax evasion.

However, the presumption in international investment agreements between developed countries is that foreign investors are at an initial disadvantage to established domestic firms and regulatory authorities. In the case of developing countries - particular small or poor ones - the reverse may be the case. This asymmetry should be the concern of international regulatory arrangements.

The current draft of the Multilateral Agreement on Investment (MAI) represents the consolidation of existing arrangements between OECD members, with provision for subsequent voluntary accession by non-members. This seems to imply accession by a limited number of middle-income industrialising countries in the immediate future. If adopted, the MAI is likely to become the benchmark for future international investment agreements.

International principles and declarations on environmental protection, core labour standards and the OECD guidelines for the behaviour of multinationals are recognised, but not incorporated as binding into the text of the agreement nor made to prevail over its provisions. Only the environmental principles set out in the Rio Declaration could be construed, under the present draft, to be a binding parameter of interpretation.

Concerns exist among some developing countries that the MAI will involve a loss of economic sovereignty, and prevent the pursuit of their chosen industrialisation strategies. A number of NGOs are concerned by the prospect of the Agreement leading to lower labour and environmental standards world-wide. We do not find that either of these concerns is justified by the existing proposal.

Although there are no specific provisions in the MAI for developing countries as such, the rules for country-specific exceptions leave sufficient scope in principle for developing country interests. Further, there is a real cost to developing countries of non-accession in terms of lower potential growth, and a significant danger of downward regulatory competition for foreign investment between those poor countries which are unable to join.

Domestic legislation conforming to the principles of “national” and “most favoured nation” treatment is required under the MAI. The “absolute” standards on investment protection are essential to improve the investment climate in LDCs, through the “import” of credibility, stability and transparency. The scope and application provisions for the treatment of foreign investment and foreign investors are appropriate for developing countries in principle. The transparency requirements in the Agreement should strengthen market institutions in developing countries, as will the dispute procedures - although both would be expensive for poor countries.

The restrictions in the MAI on performance requirements and other controls do not constitute a serious disadvantage for developing countries, as there is a wide margin for exceptions. The general exceptions

(for national security or public order reasons) and safeguards (for monetary, balance of payments and other macroeconomic disequilibria) to the application of the MAI are a crucial condition for the accession of developing countries.

The MAI will not affect re-negotiation of existing debt, nor limit monetary or exchange rate policy under IMF rules. Although the requirement to liberalise investment in the financial sector is likely to be positive for developing countries in the long run, the experience of capital surges shows that the establishment of strong regulatory bodies must precede any such liberalisation.

Domestic tax measures are excluded from the MAI, except with respect to expropriation and transparency, which provides for the fiscal policy flexibility developing countries need. However, the MAI fails to tackle the problems of double taxation and off-shore investment, which can lead to serious loss of scarce fiscal resources.

The role of aid donors in supporting the accession of developing countries to the MAI would be crucial, and it would be inconsistent for OECD members to promote such accession among poor countries without providing the resources required to make this feasible. This would principally involve technical assistance to strengthen the regulatory and legal capacity of developing countries.

A tax agreement with acceding developing counties should be established as a complement to the MAI, in order to ensure an equitable allocation of scarce fiscal resources. An accelerated programme of debt relief (beyond that offered under the HIPC initiative) should also accompany accession, in order to reduce the macroeconomic uncertainty faced by potential investors.

There already exist a broad range of regional and multilateral arrangements on investment-related issues which have the advantages of being clearly linked to trade agreements, involving developing country participation, and incorporating effective dispute resolution procedures. Effective regional agreements involving investment issues also exist in a number of cases, where the interests of developing countries are adequately represented.

It is thus not clear that in its present form the MAI is in fact a multilateral investment agreement “of the highest standard” as was originally intended, due to the large range of exceptions claimed by the potential signatories on the one hand and its ambiguous relationship to non-investment issues, effective disputes procedures and WTO commitments on the other.

If the accession to the MAI of all developing countries willing to do so is not feasible due to lack of consensus among OECD members, or the negotiating timetable becomes further delayed, the pursuit of a comprehensive multilateral investment agreement in the wider forum of the WTO should be considered. Such an option would provide for direct representation of developing countries and imply a number of additional benefits. These would include compatibility with existing trade agreements, a more effective dispute settlement procedure, and greater scope to address competition, liberalisation and incentives issues.

1. INTRODUCTION

Foreign investment is one of the driving forces of globalisation; carrying ideas, jobs and export markets as well as capital from industrial to industrialising countries. Most economic development strategies are now based on attracting foreign firms, while both large domestic firms and stable governments can rely on access to international financial markets to fund their activities. While this process has been generally positive in the sense of stimulating economic growth in developing countries, if not necessarily in reducing poverty, the rapid changes involved clearly create both losers and winners, and it is the role of international regulations and national authorities to ensure that the economic benefits are maximised while the social costs are minimised - particularly among the poor countries.

OECD members launched negotiations in 1995 for a Multilateral Agreement on Investment (MAI), which was originally due to be signed in 1998 but may be delayed to 1999 or beyond. The MAI builds on existing OECD investment instruments, and would be the world's first multilateral agreement establishing comprehensive and binding rules for investment providing market access, legal security and a 'level playing field' for international investment flows. Negotiation is between OECD members only - with a few non-members as observers - but the MAI is intended to be eventually open to accession by non-member countries. This depends not so much on their level of economic development as such, but rather on their readiness and capacity to enter into high standard and legally binding commitments and to implement these commitments effectively.

For developing countries, membership of the MAI would bolster the confidence of not only foreign but also domestic investors - by ensuring that the policy regime is unlikely to shift in the future due to the cost of withdrawal of a multilateral agreement of this type. Even for those developing countries not able or willing to accede, it would provide the benchmark for evaluating the standards and quality of their investment regimes. However, these non-acceding countries would not benefit from the credibility among international investors provided by 'locking in' to a multilateral investment agreement.

Thresholds regarding eligibility standards and core obligations have yet to be set; nor is it clear to what extent the standards of the MAI could be relaxed in non-member accession negotiations. Thus the scope for creating special conditions for developing countries is not yet defined. However, for countries intending to accede (or at least converge) to these standards, donors anticipate the provision of assistance in related capacity-building.[1]

As the MAI negotiations have progressed, growing concern has been expressed about its development implications. On the one hand, a number of developing countries have criticised their lack of representation in negotiations which will inevitably affect the whole world economy - and in particular the implications that subsequent accession or convergence would prevent interventionist policies in support of domestic firms. The MAI might even preclude negotiations in the WTO where they would be better represented. On the other hand, a number of non-governmental organisations (NGOs) have become concerned by the apparent exclusion of strict safeguards on labour standards and environmental protection from the MAI, arguing that this exclusion will lead to foreign investors being able to bid down these developmental objectives as poor countries compete for scarce capital resources.

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[1] DAC (1997)

In this study we address the issue of the development implications of the MAI in an objective manner, and in particular its effect on those poor nations classified as 'low income countries' (LICs). We are not concerned, therefore, with an evaluation of the Agreement as a whole insofar as it affects the original OECD signatories. Its general relationship with other multilateral economic arrangements will only be assessed from a development perspective. Moreover, we shall only consider developing countries as *recipients* of foreign investment. This means omission of a discussion of the interests of those more advanced developing countries whose own corporations are - to a significant and growing extent - investing overseas.[2]

In Section 2 of the study, we discuss the issue of the relationship between poor countries and international investment in order to establish the 'development interest' which might reasonably be reflected in an international agreement such as the MAI. Armed with these criteria, we examine the proposed text of the MAI itself in Section 3, exploring its provisions in detail to see how they would affect any developing country that became a signatory or adopted similar provisions into its domestic legislation. In Section 4 we then compare the MAI itself - and the negotiating process it involves - with other bilateral and multilateral agreements, and in particular with the WTO process. We can thus address the issue of the developmental impact of the MAI in Section 5 in the appropriate context of national and international development. Finally, we put forward some policy recommendations for further debate in Section 6.

Readers of this study of the development implications of the MAI should bear in mind the following two caveats:

> *First*, that the discussion is based on the *Consolidated Text* of the MAI dated 12 February 1998 provided by the OECD (OECD, 1998a) and the accompanying *Commentary* (OECD, 1998b). As the negotiations are still incomplete, the text is ambiguous at many critical points, so that quite often we have been obliged to comment on what we understand to be the spirit of the proposals.
>
> *Second*, that this study was commissioned by the DfID on 23 February 1998 for delivery four weeks later. In this short space of time, our research has inevitably been based on available documentation and our experience of the field. Unfortunately we were unable to consult international bodies, non-governmental organisations or - most importantly - representatives of the developing countries.

We are responsible for all the opinions and interpretations in this study - as well as for any errors of fact that may have escaped our notice.

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[2] UNCTAD (1997)

2. THE ISSUES: POOR COUNTRIES AND INTERNATIONAL INVESTMENT

The Globalisation of Investment Flows

The increasing globalisation of capital markets is widely regarded as a unique opportunity for poor economies to accelerate their rate of growth by accessing financial resources and productive technology, and thus to reduce poverty by generating new jobs and providing fiscal resources for human development.[3] Nonethe- less, this new source of finance requires developing countries to adjust their economies to the 'discipline' of world markets because failure to meet the standards required by foreign investors will be penalised by lower investment and growth as capital resources move elsewhere.[4] In consequence there is a growing concern that those poor countries - and vulnerable groups within industrialising countries - which are unable to compete effectively in the global marketplace will face increasing risks of social stress and declining living standards.[5]

Over the past decade the scale and form of capital flows to developing countries have undergone a profound transformation. This has key implications for these countries' interest in the formation of international investment rules. Table 2.1 reflects these changes in relation to the net capital flows from OECD members to developing countries since 1988. Among the most important changes are:

> the increase in total net flows of resources towards developing countries over the past decade, which in 1996 were three times higher than in 1988 in nominal terms, and over double in real terms; about two-thirds of these resource flows towards developing countries originate in OECD member countries;

> the shift away from non-market (or 'aid') flows towards market (or 'private' flows); market flows having risen from one-third to two-thirds of the total between 1988 and 1996; while aid flows have fallen in real terms even when rising NGO grants are included;

> the relative importance of direct investment, which represents the largest single form of private capital flow towards developing countries; but which has been overtaken recently by bond issues, short-term bank lending and other portfolio investments.

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3 IMF (1997)

4 World Bank (1996)

5 UNRISD (1996), which was the official background study for the World Summit on Social Development in Copenhagen.

Table 2.1 Total Net Resource Flows from OECD Members to Developing Countries 1988-96, US$ billions

	1988	1991	1994	1996
Non-market Flows				
Official Development Assistance (ODA)	47.6	58.6	60.5	58.2
Other Official Development Finance (ODF)	13.6	11.1	11.4	8.2
Grants by Non-Governmental Organisations (NGOs)	4.2	5.4	6.0	6.0
Sub-total	65.4	75.1	77.9	72.4
Market Flows				
Direct investment	18.7	21.0	44.9	60.0
International Bank Lending	7.8	11.0	42.6	70.0
Total Bond Lending	2.0	4.9	32.0	86.0
Other Private Flows at Market Terms	1.6	6.7	14.1	15.5
Sub-total	30.1	43.6	133.6	231.5
TOTAL	95.5	118.7	211.5	303.9

Source: DAC (1998) Statistical Annex, Table 1

Foreign Direct Investment

Foreign direct investment (FDI), which involves investment decisions within firms (eg between headquarters and affiliate) and usually concerns the transmission of technology and management skills as well as capital resources, has grown very rapidly. As Table 2.2 indicates, annual global flows have more than doubled over the past decade; while flows to developing countries have increased more than five-fold.[6]

[6] The FDI figures in Table 2.3 are considerably larger than those in Table 2.1 due to a difference in definitions. The OECD only includes the change in the net worth of subsidiaries in a recipient country on the DAC List of Aid Recipients as shown in the books of parent companies in OECD countries. UNCTAD uses flow data from the balance of payments for all developing countries, implicitly including all source countries.

Over the past decade, the share of developing countries in total FDI has risen from less than one-fifth of global investment in 1985-90 to over one-third in 1996. As far as foreign investors are concerned, developing countries not only host a quarter of all their outward investment stock already but also represent a dynamic attraction for the future. They already account for nearly half of global production and a third of world exports, and in view of their high investment rates, over half of all fixed capital formation the world today.[7]

Investment in most host regions in the developing world is dominated by three industrial 'countries': the EC is the source of most investments in Africa and eastern Europe, Japan of those in Southeast Asia and the US dominates investment in Latin America.[8] Moreover, these capital flows are highly concentrated by destination. Of the total flows to developing countries, some three-quarters are in fact received by only ten developing countries.[9] By regions, Asia and Latin America receive about one half and one third respectively, while Africa receives less than five percent. Significantly, the least developed countries account for less than one percent of total flows; and flows to these countries have grown much more slowly than those to the rest of the world.

Table 2.2 Foreign Direct Investment (FDI) Inflows 1985-96, US$ billions

	1985-90	1992	1994	1996
World	141.9	173.8	238.7	349.2
Developed Countries	116.7	119.7	142.4	208.2
Developing Countries:	24.7	49.6	90.5	128.7
Africa	2.9	3.2	5.5	4.9
Latin America	8.1	16.2	27.0	38.6
Asia	13.5	29.6	57.5	84.3
Central & Eastern Europe	0.4	4.4	5.9	12.3
Least Developed Countries	0.6	1.5	1.0	1.6

Source: UNCTAD (1997) Table B.1

When these flows are considered as a proportion of total gross fixed capital formation in a recipient country (see Table 2.3), it becomes clear that in relation to the domestic economy, FDI is in fact of similar

[7] Calculated from IMF (1997)

[8] UNCTAD (1991)

[9] In 1995, the 'top ten' host countries (Argentine, Brazil, Chile, China, Hong Kong, Indonesia, Malaysia, Mexico, Singapore and Thailand) accounted for 77% of all FDI flows to developing countries (UNCTAD, 1996).

importance in Asia and Africa, although it is higher in Latin America. Indeed, this proportion is remarkably similar in developed and developing countries, reflecting the degree of integration of world capital markets. Moreover, these figures understate the importance of FDI to developing countries: in fact, between one third and a half of private corporate investment in developing countries is undertaken by the affiliates of multinational corporations (MNCs). [10]

For a considerable number of small poor countries, foreign investment - including investments by expatriate nationals - can be the principal source of modern corporate expansion. However, the proportion of capital formation provided by FDI, as Table 2.3 shows, is much lower than that for developing countries as a whole. It is this imbalance which an multilateral investment agreement should seek to address.

Table 2.3 FDI Inflows as a percentage of Gross Fixed Capital Formation, 1985-95

	1985-90	1992	1995
World	5.4	3.3	5.2
Developed Countries	5.5	3.2	4.4
Developing Countries:	8.0	5.1	8.2
Africa	4.7	4.7	6.9
Latin America	11.3	8.1	11.0
Asia	7.6	4.2	7.5
Central & Eastern Europe	1.0	0.8	5.2
Least Developed Countries	2.3	2.0	1.3

Source: UNCTAD (1997) Table B.5

The three main reasons for trans-national firms to invest in developing countries are natural resource availability, a large domestic market, and a suitable platform for manufacturing exports. The choice of a particular country depends on the strength of local institutions, the quality of local infrastructure and

[10] Public investment accounts between a third and a half of gross fixed capital formation and household investment (in house building, family farming, etc.) a similar proportion of non-public investment. In consequence, 'corporate' investment by private companies in fact makes up as little as a third to a half of fixed investment in developing countries. Moreover, measured FDI only reflects that part of a subsidiaries' investment financed by the parent companies; which again can be as little as a half once local and international external debt is taken into consideration. In sum, the true proportion of corporate fixed investment in developing countries that is undertaken by foreign firms is probably four or five times greater than the figures shown in Table 2.2.

workforce, and the degree of macroeconomic stability. In this context, a country with a liberalised pro-business economy will clearly be more attractive - particularly if these characteristics are expected to be permanent.[11] Over the past decade, privatisations have attracted considerable flows of foreign investment due both to the low price of assets, improved management possibilities and markets for technology on the one hand, and the signal that privatisation creates to international markets that liberalisation is permanent. Indeed the IFC estimates that foreign investors accounted for 42 percent of the total proceeds from privatisation in developing countries between 1988 and 1994.[12]

There is no evidence that large MNCs corporations from OECD countries will be attracted to countries without these characteristics by the offer of subsidies or low labour standards - which do not provide a basis for long-term profitability. Stricter environmental controls than in comparable countries may be a disincentive, but again other factors such as resource availability or market size tend to be more important.

Fiscal incentives (whether tax reductions, subsidies or state bank loans) may be justified in principle if the extra benefits to the local economy are greater than the fiscal cost. There is evidence that the scale and scope of foreign investment incentives have increased considerably since the 1980s. A comprehensive study by the UNCTAD concludes that “trends in FDI incentives around the world show that competition for FDI with incentives is pervasive, and that it is even more intense than it was some ten years ago”.[13] Competition between developing countries of this kind is, of course, wasteful. Raising the *average* level of incentives mainly benefits MNCs, while raising *marginal* incentives may only benefit one developing country at the expense of another.

There is some empirical evidence to suggest that some host countries - both developing and developed - have encouraged the transfer of environmentally sensitive activities by offering the least costly environmental restrictions.[14] This appears to be particularly true of the production of highly toxic products and some hard minerals processing.

Nonetheless, smaller or less scrupulous foreign investors - often from the same region, representing expatriates or even channelling illegal funds - are often attracted to poor or weakly administered economies by poor labour and environmental standards, or the prospect of benefiting from fiscal resources. A number of large multinational firms also continue to take indirect advantage of these conditions by sourcing from the use of domestic sub-contractors in labour-intensive or environmentally-sensitive sectors; although they cannot be legally called to account for doing so.
Until the 1980s, market-seeking FDI predominated in manufacturing, adding to traditional investment in primary exports. Import substitution policies in many less developed countries encouraged ’tariff-jumping’, and local value added was normally low. More open trade and investment regimes in developing countries over the past decade mean that MNCs now take advantage of low cost labour and intermediate inputs in host economies to construct export bases for both the region and the home economy. In the 1990s, attracted by privatisation and other economic reforms, investors have increasingly entered infrastructure and utility sectors such as power, water, telecommunications, and public transport.[15] With

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[11] See Dunning (1993), IFC (1997) and UNCTAD (1996)

[12] Bouton and Sumlinski (1996)

[13] UNCTAD (1995), p.25

[14] Dunning (1993)

[15] UNCTAD (1996)

the surge of FDI into the service sectors of developing countries national governments now face a host of complex regulatory issues.

Complex production-related activities, such as R&D, financing or marketing, are all part of the MNC's foreign operations. These developments mean that foreign owned firms now perform a much wider range of production activities. Key managerial personnel need to move around the world unhindered. Moreover, the dividing lines for what are considered foreign owned assets have become increasingly unclear. Investors increasingly seek protection not just for physical assets but also for small (portfolio) equity stakes, intellectual property rights and capital goods provided on a temporary basis.

International Investment Rules

Over the past 15 years developing countries have embarked on an unprecedented unilateral liberalisation of their investment regimes. They have attempted to construct a strong business environment based on market growth, solvent financial systems, working infrastructure, and laws and regulations that are fairly enforced. Stability, transparency and objectivity in policy making are also desired - leading in many cases to the independence of central banks and the accession to international agreements in order to enhance the credibility of the new economic regime.

International investment agreements are thus intended to 'lock in' this liberalisation and thereby enhance investor confidence in regulatory environments. The investors in question are not only multinational firms. On the one hand, 'expatriate' capital (that is, the assets of nationals held overseas, whether their owners are resident or not) will be encouraged to return to its 'home' economy by credible investment guarantees. On the other hand, domestic investors themselves will regard foreign investment regulations as a strong indication of the treatment that they themselves will receive.

International investment agreements involve much more than the baseline conditions for investment liberalisation listed above. Equitable and non-discriminatory treatment of foreign investors is required, as are appropriate conditions for transfer of funds, taxation, performance criteria and corporate practice. Investment protection provisions should also address such issues as expropriation and protection from civil strife. International agreements - such as bilateral investment treaties, double taxation treaties, regional trade agreements and certain WTO provisions - play key role in building investor confidence by locking in policy commitments over time.[16] In particular, there is a close relationship between trade and investment agreements at the bilateral, regional and multilateral levels.

The accelerating trend towards bilateral, regional and multilateral arrangements for investment regulation[17] thus reflects a move away from national rights to control foreign investment and norms for corporate conduct. Such new agreements are usually based on general standards of treatment; coupled with norms on specific matters such as expropriation, compensation and the transfer of funds, and mechanisms for the international settlement of disputes. Their main features are: a 'top down' approach to the liberalisation of investment regimes through the application of national treatment and MFN regimes to both the establishment and the subsequent treatment of investment; a broad asset-based definition of investment; provisions on country-specific reservations; standstill and provision for continuing liberalisation ('roll-back'); provisions on the transparency of domestic laws, regulations and policies; a

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[16] WTO (1996)

[17] These are listed in UNCTAD (1996); see also the discussion in Section 4 below.

limited set of general exceptions; and standards for the protection of investments. They also include dispute settlement procedures through state-state arbitration and investor-state arbitration.

Criteria for Evaluating the Development Implications of Investment Agreements

Any judgement as to the development implications of the MAI should take into account the impact of membership (or non-membership) of the Agreement on foreign investment and sustainable economic growth in developing countries on the one hand, and on the relationship between developing countries and the rest of the world economy on the other. These are, respectively, the subjects of Sections 3 and 4 below. Here we set out what we believe to be the relevant criteria for making such a judgement.

At the outset it must be accepted that international capital flows are a central characteristic of the global economy of which developing countries increasingly form a part. The MAI cannot be judged from the standpoint of whether foreign investment is ‘a good thing’ as such, but rather from that of whether such an arrangement enables the relationship between foreign investment and sustainable development to be strengthened. Again, the MAI is a set of rules about international investment and investors, and thus cannot be judged in terms of its effectiveness as a vehicle for international norms on other issues such as human rights, labour standards or environmental safeguards[18] - although it certainly should not conflict with international agreements on these topics.

Our task in this study is to establish relevant criteria for examining the MAI from the point of view of developing countries. Thus, even though the current draft of the Multilateral Agreement on Investment (MAI) represents the rationalisation of existing arrangements between OECD with voluntary accession for other countries, in fact that it will probably become the benchmark for future arrangements makes it relevant to all developing countries. There exists a potential danger of regulatory competition between poor countries leading to a lowering of standards. Moreover, the presumption in international investment agreements between developed countries is that foreign investors are at an initial disadvantage to established domestic firms and regulatory authorities.[19] In the case of developing countries - particular small or poor ones - the reverse may be the case. This asymmetry should be the concern of international regulatory regimes.

Developing countries can have special problems in terms of their economic, social and administrative vulnerability to sudden changes in the world economy, or to pressures from more powerful members or even from large MNCs. Substantial investments in particular sectors such as natural resources (eg energy, mining), manufacturing (eg export zones, refineries) or services (eg banking, tourism) may in fact have strategic implications because of their size relative to the host economy. Similarly, foreign firms may be very large relative to domestic firms, making ‘national treatment’ an ambiguous concept; and even requiring special protection for small firms.

In contrast, we do not believe that poverty reduction can be employed directly as a criterion for judging the MAI or any other investment agreement. This is because poverty depends on a wide range of national and international factors of which foreign investment is as much a consequence as a cause. None the less,

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[18] Particularly if these norms – however desirable ethically – are proposed by developed countries and opposed by developing countries.

[19] Such as the OECD Codes of Liberalisation and Declaration on International investment, which commit member countries to liberalise rules and regulations affecting cross-border capital flws and to provide national treatment to foreign-controlled enterprises.

to the extent that foreign investment rules affect the rate of sustainable economic growth, the level of employment and skills, or the fiscal capacity to deliver public services to all citizens, then the poverty criterion can be expressed indirectly.

Finally, it is clearly necessary to distinguish between developing countries themselves in two senses. On the one hand, large economies are in a stronger bargaining position than small ones with respect to foreign investors due both to their market importance to the investor, and to their stronger government capacity. On the other, the more advanced developing countries - that is, the middle-income (or 'industrialising') countries as opposed to the low-income (or 'poor') countries - generally enjoy more effective administrative and regulatory systems, and thus are in a better position to handle foreign investment rules. [20]

In consequence, we propose to apply the following three criteria to the MAI in relation to the *national* development consequences of accession:

> How would accession affect the level and quality of foreign investment, in the sense of encouraging high levels of physical and human capital formation?
>
> Would accession constrain the exercise of domestic economic policy in support of development objectives; and would it improve fiscal solvency - in the sense of revenue capacity or debt overhang?
>
> Would accession strengthen the domestic private sector, which is the main generator of output and employment; and would it enhance the capacity of the domestic authorities to provide effective market regulations?

In relation to the *international* development consequences of the MAI, our three criteria are the following:

> Would accession improve the credibility of developing countries as investment hosts, and what would be the consequences for those countries unwilling or unable to join?
>
> Would accession help developing countries overcome the externalities associated with international co-ordination problems associated with the global environment, competitive deregulation, tax evasion and the fight against crime?
>
> Would the MAI be compatible with other international economic agreements and liberalisation processes, and is it to the advantage of developing countries to accede to an agreement in the design of which they have not participated?

In principle, we can distinguish between four distinct groups of developing countries in relation to negotiations for the MAI:

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[20] For the listing of countries, see DAC (1998) or World Bank (1997). Middle-income countries are defined as those developing countries with per capita GNP of $766-9,385 in 1995; the low-income countries being those with per capita GNP of less than $765.

A) Those developing countries which are already members of the OECD (Mexico, South Korea) or observers at the negotiations (Brazil, Chile, Argentina, Slovakia and Hong Kong), most of which are expected to accede in the short run;

B) Those large developing countries (such as India or Brazil) which can expect to negotiate accession on their own terms when they so choose, in view of their role in the world economy;

C) The rest of the middle-income countries, which are expected to be in a position to accede if they so wish in the medium term under the terms of the present MAI proposal;

D) And the rest of the low-income countries, which are not expected to be in a position to accede except in the long run under the present proposal, but which could do so under special transition arrangements and with international assistance.

In the rest of the report we shall focus on Groups C and D, and in particular on group D in view of the concerns of the Department for International Development. For ease of exposition, we shall refer to Group C as ‘industrialising’ or ‘middle income countries (MICs)’; and to Group D as ‘poor’ or ‘low income countries’ (LICs).

3. AN ANALYSIS OF THE PROPOSED MULTILATERAL AGREEMENT ON INVESTMENT[21]

I. General Provisions

The Preamble to the MAI encompasses four broad sets of formulations:

> Reference to the circumstances shaping the context of and the need for the MAI, including: the growing importance of FDI; the role of FDI in the world trading system as embodied in the WTO; and the economic impact of FDI. Explicit reference is made to the contribution of international investment to economic development, and to the expected positive effects of the MAI on the living standards of the signatory countries.
>
> A declaration concerning the specific scope and objectives of the MAI (i.e. the establishment of multilateral rules for international investment), providing for high standards of investment regime liberalisation and investment protection (substantive) and an effective dispute settlement mechanisms (procedural)
>
> A recognition of certain international principles, rules and standards to which the contracting parties declare to be committed, including: environmental protection, sustainable development and international environmental law (with explicit reference to the 'Rio Declaration on Environment and Development' and 'Agenda 21'); core labour standards (noting that the ILO is the competent body to deal with them); and the OECD Guidelines for Multinational Enterprises (whose non-binding legal nature is expressly highlighted).
>
> And a declaration on the nature of the MAI as a "free-standing Agreement open to accession by all countries".

Although the direct legal applicability of preambular declarations is controversial, their fundamental role as primary sources of legal interpretation in case of ambiguity or inconsistency, is not in dispute. In this respect, the following two issues should be noted.

First, that economic development is assumed as a positive externality arising from the MAI, but it is neither postulated as a binding parameter of interpretation of the agreement, nor is it made a direct objective of the MAI itself. This has important implications for LDCs: the investment liberalisation and protection provisions of the MAI would prevail, even if deemed temporarily inconsistent with effective developmental policies followed by a signatory country, unless covered by a specific exemption.

Second, only the principles of international environmental law, as reflected in the Rio Declaration, could be construed to be directly applicable as parameters of interpretation for the implementation of the agreement. Although the parties affirm *their* commitment to other guidelines (such as core labour standards and OECD's guidelines for the behaviour of multinationals), they do not affirm the subjection of

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[21] Throughout the analysis is based on the Consolidated Text of the MAI, as of 12 February 1998, provided by the OECD (OECD, 1998a); and the headings with roman numerals refer to those in this text. Mo explicit comment is made on minor provisions where the estimated impact on developing countries is deemed to be negligible.

the *MAI itself* to such principles. Core labour standards are explicitly stated not to be under the competency of the agreement, while the OECD guidelines on multinationals are maintained as non-binding and voluntary.

II. Scope and Application

The MAI is built upon a broad, asset-based definition of investment, which includes not only foreign direct investment as such, but also the direct or indirect ownership or control of any other asset. For instance, portfolio investment and all sorts of asset management by residents or nationals of contracting parties through offshore companies would be covered under the MAI.

The following issues are relevant from a developing country perspective:

> At first sight, the inclusion of portfolio investment under the disciplines of the MAI (particularly NT and MFN) would seem to restrict the ability of governments to impose controls on volatile capital inflows. However, contracting parties are allowed (Section VI of the MAI) to adopt temporary non-conforming measures in the event that cross-border capital transactions cause or threaten to cause external financial difficulties or serious difficulties for the conduct of monetary or exchange rate policies. This temporary safeguard might be of crucial importance for developing countries faced with large exogenous capital surges.
>
> Contract-based rights with governments are included in the definition of investment under the MAI. This affects concessions, authorisations and licenses in key development sectors such as natural resources and tourism. Lodging of sector-specific exceptions might be necessary in such cases.
>
> Many foreign investors control their investments in LDCs through offshore holding companies, often incorporated in tax havens. In some cases, this is done for tax evasion or money laundering purposes. The inclusion and protection of indirect ownership under the MAI is, in this context, a potential problem for recipient LDCs.

III. Treatment of Investors and Investments

National Treatment (NT) and Most Favoured Nation Treatment (MFN)

The MAI provides that contracting parties shall accord to investments protected under the agreement, treatment *no less favourable* than that accorded to its own nationals' investments (NT) or to investments from any other country, whether or not a party to the MAI (MFN); and in any case, shall accord to them the more favourable of NT and MFN. Both NT and MFN are *relative* standards of treatment, i.e. they refer to other already existing bodies of rules in the recipient country. This implies that the investment treatment accorded to a foreign investor under the MAI has to be, *at least* as favourable (but not necessarily more), than that already provided for in the domestic legislation applicable to both local investors and other foreign investors. Therefore, NT and MFN determine the rules applicable to foreign investment by referring to the host country's domestic law. This, in turn, has important implications for developing countries.

> In the case of host countries characterised by lack, incompleteness or inconsistency of legislation applicable to investment, foreign or domestic, the MAI -by remitting to local laws- will be incapable of providing foreign investors with the necessary level of certainty to stimulate investment flows. The weakness of the legal systems and of the rule-making institutions is especially pervasive in LICs.

> Furthermore, NT and MFN are not only relative but also comparative, in the sense that they are applicable only where the situation of the investors concerned is comparable (*in like circumstances*). But, in many respects, foreign firms are not easily comparable to domestic ones, particularly to those of LICs. This makes NT difficult to apply in particular cases, and may create further uncertainty.
>
> The language used in the NT and MFN clauses (*no less favourable than*) explicitly rules out, in principle, any discriminatory treatment (de facto or de jure) against foreign investors, but allows instead for privileged treatment to foreign firms (over and above the treatment granted to domestic firms). The implications for developing countries are discussed in Section 5 below.

Overall, the nature of NT and MFN as relative standards confers a certain degree of policy flexibility to host countries, provided that policy design is exercised in a non-discriminatory manner and within the limits imposed by other clauses of the MAI (particularly standstill and immigration provisions). This may be positive for MICs where the levels of institutional development and the investment climate are reasonable by international standards, but may be of less help to the LICs.

Transparency

The MAI requires each contracting party to publish or make publicly available all its laws, regulations, procedures, rulings and decisions -administrative and judicial- pertinent to foreign investment. This is an important measure towards reducing the degree of regulatory uncertainty facing foreign investors in LDCs. However, it would probably represent an excessive administrative and financial burden for many developing countries, particularly poor or small ones.

The current text of MAI safeguards the right of host countries to require of a foreign investor the provision of relevant information. This is important for domestic tax and statistical purposes.

The MAI also secures the right of host countries to deny the authorities of other countries access to information protected under domestic confidentiality rules. However, this latter provision allows for the persistence of tax haven jurisdictions, which encourages not only tax evasion (especially from developed home countries), but also investment diversion detrimental to most (non-tax haven) developing countries.

Temporary entry, stay and work of investors and key personnel

The obligation of signatories under the MAI to provide entry, stay and authorisation to work to key personnel is beneficial for developing countries. Admittedly it may be more controversial in the more developed MICs, where there is a larger domestic supply of managerial and highly skilled labour who might be displaced from potential employment in NNC affiliates. However, it may be equally important for developing countries to include a provision explicitly guaranteeing to the entry, stay and work of employees from recipient countries into home countries[22], so that the flows of labour are guaranteed in both directions.

Performance requirements

This is one of the most controversial aspects of the MAI, and perhaps also one of the most poorly understood by critics. The following elements of the current proposal are thus worth noting:

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[22] In other words non-OECD nationals could freely enter and work in OECD countries as employees of *either* the affiliate located in a developing country of a MNC domiciled in a OECD, *or* of a OECD-located affiliate of a developing country firm.

The MAI prohibits the imposition or enforcement upon a foreign investor, as a condition for the establishment, acquisition, expansion or disposition of an investment, of any one of the following performance requirements: a) trade-related: ratio of exports to total sales, domestic content, local purchases, ratio of imports to exports, ratio of local sales to exports; b) transfer of technology (except when used to remedy violations of domestic competition laws); c) location of headquarters; d) research and development; e) employment of locals; f) minimum or maximum level of equity participation. However, any contracting party may impose the performance requirements listed from b) to f) above if linked to the granting of an advantage, which significantly weakens this restriction.

Trade-related investment measures (i.e. the requirements listed in paragraph a)) may not be imposed in any case, even when linked to the granting of an advantage, except with respect to: export promotion policies (e.g. export processing zones), foreign aid programmes, the production, processing and trade of agricultural or processed agricultural products, advantages related to trade in services, and preferential tariffs or quotas.

There is a proposal to include a provision whereby limits on the imposition of requirements concerning domestic content and purchase of (or preferential treatment to) local supplies should not prevent a contracting party from adopting measures necessary to protect human life or the environment. An alternative proposal (based on the text of NAFTA, and presented to the Negotiating Group as part of the 'Package of Additional Environmental Proposals' on 14/1/98), is to generalise the environmental exception to all the provisions of the agreement[23].

It is understood that customs duties or exemptions therefrom do not constitute prohibited TRIMs. Further, these provisions shall be implemented without prejudice to the rights and obligations acquired by the parties under the WTO agreements (i.e. the latter prevail). This implies that developing countries will have substantial flexibility to use selective tariff policies as long as they are consistent with WTO commitments.

Clearly, therefore, the current text of the MAI is far from mandating an across-the-board derogation of all performance requirements, as is commonly believed.
In assessing the potential impact of these provisions for developing countries, the following issues are worth noting:

The list of performance requirements regulated by the MAI is closed (*numerus clausus*). Any other requirements on standards of behaviour that host countries may wish to impose to foreign investors would conform to the MAI, as long as they are non-discriminatory (i.e. consistent with the NT and MFN clauses). Of particular importance may be: labour and environmental standards, consumer protection and restrictive business practices. However, it might be very important for developing countries that the language of NAFTA on environmental protection measures be adopted, to ensure that such measures are indeed taken but not used as a disguised restriction on investment outflows from developed home countries.

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[23] Article 1114 of NAFTA also provides that no environmental measure shall be adopted as a disguised restriction for investment outflows or inflows.

Regarding local content requirements, foreign exchange balancing and export limitation requirements with respect to trade in goods, the MAI will not affect the rights and obligations (including the phasing-out schedules) already acquired by developing countries under the WTO TRIMs Agreement. Export promotion and foreign aid programmes will not be affected either, neither will requirements related to agricultural or processed agricultural products. These exemptions should provide sufficient flexibility to developing countries still undertaking structural transformation from import-substitution policies and adjustment from external debt overhangs[24].

The derogation of location of headquarters requirements is not likely to have any negative effect on developing countries. The same is generally true for equity participation restrictions, though some LDCs may wish to make reservations about opening up specific sectors.

Moreover, the current text of the MAI (Section III, article on public debt) explicitly provides that public debt *rescheduling* (though not public debt itself) falls outside the MAI disciplines (e.g. it will not be subject to NT or MFN clauses). There is general agreement on this issue among the negotiating delegations. Thus, public debt management flexibility is guaranteed by the MAI.

The derogation of local employment requirements might be a cause for concern. However, in practice, these are extremely unlikely to be quantitatively significant in curbing unemployment, and are liable to be inconsistent with technology transfer policies.

The most controversial of the performance requirements listed in the MAI are probably those referring to technology transfer and R&D. Under the current text, technology transfer and R&D requirements may continue to be imposed when linked to the granting of an advantage. The term ‘advantage’ is not defined in the text, and therefore it must be understood in a broad sense (i.e. including all forms of tax and financial benefits/breaks/subsidies, access to resources, technical co-operation). Consequently, the MAI allows for a broad array of government policies to promote (through specific incentives) the transfer of technology from foreign investment.
Requirements concerning the transfer of intellectual property are not derogated, as long as they are consistent with the Trade Related Intellectual Property Agreement (TRIPs). Moreover, the commitments to transfer technology to developing countries (especially the LICs), acquired by developed countries under TRIPs and the General Agreement on Trade in Services (GATS), are not affected by the MAI.

In conclusion, the performance requirement provisions of the MAI are not as far reaching or as negative for developing countries as some commentators have claimed.

Privatisation
The MAI rules on privatisation are straightforward: all kinds of privatisation, irrespective of their method, or rules regarding subsequent disposal of a privatised asset, must conform to the NT and MFN clauses. Special share arrangements will be considered compatible with NT and MFN, unless they explicitly and intentionally discriminate against or in favour of a particular foreign investor. The procedures and essential features of each prospective privatisation shall be made publicly available, and in accordance with NT and MFN. The agreement explicitly states that it does not pose an obligation (or a prejudice) on contracting parties to privatise.

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[24] Although the ability to re-introduce such measures again is of course, constrained.

These provisions appear to strike an adequate balance between the interests of foreign investors and those of developing countries. While they rule out arbitrary discrimination against international investment, they allow for specific (and domestically determined) privatisation mechanisms that have proved positive in developing country experiences, such as: retention of 'golden shares' (with special veto rights) by the government, voucher schemes for members of the public or specific communities, preferential treatment to employees and/or managers of privatised entities, or allocation of shares to specific groups. Thus, the MAI provides for increased transparency without reducing the existing policy flexibility.

Monopolies[25]*, state enterprises and concessions*
The MAI explicitly states that the contracting parties' right to create, maintain or eliminate monopolies is not affected by the agreement. The MAI intends to prohibit each signatory from discriminating against foreign investors when designating a monopoly, and obligates contracting parties to ensure that all monopolies or monopsonies (either state or privately-owned), as well as state enterprises, provide non-discriminatory treatment to foreign investors. Moreover, they should not abuse monopoly position or engage in anti-competitive practices that may affect foreign investors. Flexibility to make exceptions, even after the entry into force of the MAI, is explicitly granted. Transparency rules oblige to notify to other contracting parties the creation or elimination of a monopoly. Similarly, the MAI contains rules on transparency and non-discrimination in the granting of concessions, and on the granting of authorisations for the exploration and production of minerals.

Although these provisions would be very difficult to implement in practice, they would provide a step in the right direction for many developing countries. It would in effect provide an element of international discipline to limit pervasive corruption, favouritism and lack of transparency in the creation and operation of monopolies, as well as in the granting of concessions and authorisations.

Investment incentives
The MAI confirms, somewhat redundantly, that NT, MFN and transparency clauses apply to the granting of investment incentives. Whether or not the linking of an incentive to a performance requirement may lead to non-conforming discrimination (e.g. against low-tech, low investment technology) is not addressed explicitly (though it is not outlawed in the article on performance requirements). The negotiating delegations are still discussing whether they should embark on further negotiations to discipline the granting of incentives, possibly by imposing standstill and rollback obligations, in order to avoid international 'incentive competition' aimed at attracting foreign investment,

The outcome is still very unclear, therefore. Indeed, it may be impossible to reach an agreement on this issue between OECD countries who, while wishing to reduce such incentives in principle, must respond to the pressure from their own backward regions. The consequences of such a failure to agree may be serious for developing countries because the multilateral co-ordination of investment incentive policies could save significant fiscal resources.

Authorisation procedures

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[25] The definition of monopoly in the MAI does not include a person or entity that has an exclusive intellectual property right, concession, licence, authorisation or permit, solely by reason of the existence or exercise of such right.

Provisions on the transparency and expediency of authorisation procedures for investments imply that the MAI will provide for policy flexibility by host countries to impose authorisation procedures on some types of investment. Liberalisation is not mandated in this area.

Intellectual property
It is explicitly agreed that the MAI should not extend the NT and MFN obligations beyond those in existing intellectual property agreements. Therefore, the Paris Convention and WTO TRIPs Agreement will prevail, which ensures that in this area the MAI will not impose on developing countries anything that they had not previously (and directly) negotiated.

Not lowering standards
Two alternative provisions are proposed in the draft on how to avoid the lowering of health, safety, environmental or labour standards by signatories in order to encourage foreign investment: a 'soft' one, whereby any contracting party incurring in such a practice may be required to go through consultations with a view to eliminating such measure; and a 'harder' one whereby the aforementioned practice would be considered non-conforming with the MAI and subject to dispute settlement challenge. This issue is taken up again in Section 5 below.

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IV. Investment Protection
Clearly, investment protection is an issue of key importance for developing countries, particularly the poorest ones where the social and political context tends to be more unstable. The regime delineated by the MAI has the following central elements:

> Each contracting party shall accord to foreign investment *fair and equitable treatment* and constant protection and security. In any case, such treatment should be no less favourable than that required by international law. This standard of treatment is 'absolute' (i.e. it is not contingent on host country's legislation), as opposed to NT and MFN (relative standards).
>
> Expropriation of foreign investment (and measures having similar effects) shall, be limited to cases of public interest, be applied in a non-discriminatory manner in accordance with due process of law, and be subject to prompt, fully convertible and transferable compensation at fair market value. Interest rate payments or exchange loss adjustments shall be borne, when applicable, by the host country.
>
> In case of war, civil disturbance or armed conflict of any sort, compensation to foreign investors should be in accordance with the better of NT and MFN (except that loss of property occurs from requisitioning or unnecessary destruction by the host country's armed forces, in which case full compensation is due).
>
> All payments to or from the foreign investor shall be freely transferred into and out of the host country in a convertible currency. Transfers may only be delayed to protect creditors or to comply with domestic securities or criminal laws. Transfers of data and information in and out of host country shall also be freely made.
>
> The MAI would protect investments made before and after its entry into force.

These 'absolute' standards and rules for the protection of investment are essential for the improvement of the investment climate in the developing countries.

V. Dispute Settlement

State-State Procedures

In cases of dispute between contracting parties regarding the interpretation or application of the agreement, the parties must first attempt to resolve the dispute amicably through consultations (between disputing parties), multilateral consultations with the Parties Group (a permanent organ to be created by the MAI), mediation or conciliation. These proceedings, as well as the information provided by the parties therein, shall be confidential.

If the parties fail to resolve the dispute through amicable proceedings, the issue may be submitted to an arbitral tribunal. The tribunal will consist of three independent and impartial members, normally appointed by the Secretary General of the International Centre for the Settlement of Investment Disputes (ICSID), from within a roster maintained for these purposes. The tribunal may request a written report on any scientific or technical matter, by a technical review board or an expert. The tribunal, in its award, may: declare that a party has contravened its obligations under the MAI; make recommendations thereto; and award pecuniary compensation for any loss or damage to the requesting party's investor. Tribunal awards, which shall be made publicly available, are final and binding (but subject to nullification).

Each party shall pay the costs of its representation. Costs of the tribunal will be split between the parties, according to the shares assigned by the tribunal. Either party may request to an independent tribunal (constituted in the same way as above) the annulment of an award. This tribunal may nullify the award in whole or in part, in which case the dispute would be submitted to a new tribunal.

If a party fails to comply with the award, the other party may request consultations. Should these fail, the latter party may submit the issue to the Parties Group, which may decide to what extent the requesting party will be allowed to take responsive measures (i.e. suspension of the benefits to the non-complying party or its investors). A dispute on failure to comply with an award by one party may, yet again, be submitted by the other party to decision by a new arbitral tribunal. All these rules and procedures apply unless the disputing parties agree to apply others.

The provision of dispute settlement procedures between states is a standard feature of international agreements, and the rules above are straightforward. However, some issues may be of specific concern for developing countries:

> The proposed procedures are too involved and lengthy. Moreover, they may become endless (e.g. there is no explicit limit to the number of times an arbitration award may be challenged). This implies the risk that litigation be used as form of harassment to other parties.
>
> The costs of representation and (most likely) the costs of the tribunal (s) have to be borne by each party. These costs are usually very high, and barely affordable for the poorer developing countries. Moreover, most LICs may lack highly skilled litigants with expertise in international investment and arbitration procedures.
>
> It is likely that the home country will be the claimant in the dispute. Thus, time will probably run against home developed countries, but host developing countries will not be able to afford delaying the procedures through a chain of appeals. Hence, the combination of high costs and unpredictable length of the procedures, creates an incentive to negotiate off-tribunals. And here,

the bargaining power (as measured by the relative weight of each party's potential retaliation measures) would favour developed host countries.

The above analysis may call for the provision of internationally funded arbitration tribunals and pools of litigants experts in this field.

Investor-State Procedures
Disputes between a contracting party and an investor of another party concerning an alleged breach of the MAI, or of a specific obligation acquired by the contracting party under an authorisation or written agreement, should be settled amicably, or else be submitted for resolution. This could be done via: to the courts of the contracting party; in accordance with any agreed upon procedure; or by arbitration under the ICSID, the ICSID Additional Facility, the United Nations Commission on International Trade Law (UNCITRAL) or the International Chamber of Commerce (ICC). The arbitral tribunal will consist of three members, one appointed by each party and the third by mutual agreement. The tribunal may request written reports by experts on scientific or technical matters.

The arbitration award will be final and binding, and may: declare that the contracting party contravened the agreement; award pecuniary compensation or restitution in kind (when possible) of any loss or damage. The award should be complied with promptly, subject to the rights of the parties under the arbitral system utilised.

Two additional issues should be noted. First, in the procedures for the settlement of investor-state disputes only the foreign investor (and not the host country's government) may file claims. Although at first sight it appears that this involves an asymmetry, that is not the case. The host government can always file a claim with the courts of its own jurisdiction. Moreover, the MAI does not impose direct obligations upon investors. Therefore, it is not possible for the host country to base a claim on an alleged violation of the MAI by a foreign investor. Second, the same arguments raised above regarding litigation costs and lack of local expertise facing the LICs apply to investor-state dispute settlement procedures as well.

VI. Exceptions and Safeguards

General exceptions
The contracting parties are allowed to take any actions necessary for the protection of their essential security interests and of international peace, as well as for the maintenance of public order, even if such actions may contravene the MAI. However, the exception does not apply to the provisions concerning expropriation and compensation and protection from strife, which must be observed at any time.

Monetary and exchange rate policies
NT, MFN and transparency provisions of the MAI do not apply to the transactions carried out by monetary authorities as part of their monetary or exchange rate policies.

Temporary safeguards
*S*ignatories may adopt, only temporarily and subject to review and approval every six months by the IMF and the Parties Group, measures inconsistent with their obligations regarding international transfers of funds, or inconsistent with NT regarding cross-border capital transactions. This is permissible: a) in case of severe balance of payments difficulties; or b) exceptionally, when such transactions seriously hinder the implementation of monetary and exchange rate policies.

These provisions are crucial for an eventual accession of developing countries to the MAI. Of course, the scope of the exceptions is limited and subject to anti-abuse control by the Parties Group and other signatories. Otherwise, the credibility gains from MAI's policy 'locking-in' would be undermined. None the less, the current text affords sufficient flexibility for the lawful suspension of MAI's provisions in exceptional, justified cases. The problems inherent to economic development could often provide such justification.

VII. Financial Services

The MAI includes some specific provisions for the financial services sector, including: a) an exception from the application of the MAI in respect of prudential measures necessary for investor protection or ensuring the stability of the financial system (and provisions on dispute settlement when such exception is invoked in a financial dispute); b) procedures for the recognition of another contracting party's financial regulation standards; c) transparency in authorisation procedures; d) NT by self-regulatory bodies (such as stock markets and associations); e) NT in the access of foreign investors to official funding and refinancing facilities, but not to lender of last resort facilities.

The inclusion of these provisions is an acknowledgement of the unique nature of the financial system and the need for prudential regulation to ensure its stability - an aspect of particular importance to developing countries.

VIII. Taxation

The MAI excludes taxation measures from the application of its provisions, except on expropriation and transparency. Thus, the MAI excludes taxation from NT and MFN clauses, thereby giving flexibility to member countries to enter into bilateral and/or regional tax agreements or to enforce the existing ones. It also gives them flexibility to adopt discriminatory tax laws and anti-evasion policies facilitated by technological developments. The MAI also provides that a taxation measure (including direct, indirect and social security taxes) could effect expropriation for the purposes of the agreement if it exceeds the bounds of internationally recognised tax policies and practices. Tax measures will also be subject to MAI's transparency rules, within the limits set by domestic or international commitments on tax secrecy and confidentiality.

The absence of provisions on double taxation is a serious limitation of the MAI from the point of view of developing countries. We shall return to this topic in Section 5.

IX. Country Specific Exceptions

Under the MAI, each signatory country would be allowed to lodge a schedule of exceptions to the application of NT, MFN, and other provisions of the MAI (which ones is still being negotiated)[26] . The schedule will list any existing non-conforming measures which the country intends to maintain, as well as future amendments thereto[27]. The amendments must not increase the non-conformity of the measures. Acceding countries would also be allowed to lodge a schedule of sectors, sub-sectors or activities where future non-conforming measures may be adopted (though discriminatory expropriation or forced disposal by reason of nationality would be ruled out)[28].

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[26] In contrast to 'reservations' in other international treaties, these exceptions will not be understood to be reciprocal.

[27] The schedule would include: provisions of the MAI with which the exceptions do not conform, sector and subsector, level of government and legal source of the non-conforming measures, description of the measures and their motivation or rationale.

[28] Whether the lodging of the second schedule will be allowed is subject to current negotiations.

The first schedule would create a ‘standstill’ commitment under the MAI: existing non-conforming measures will be accepted but shall not be increased. The second schedule would provide an exception to the standstill: the sectors where future non-conforming measures could be adopted. This would give the MAI a greater degree of flexibility, and would certainly facilitate the accession by developing countries, some of which might have a strong interest in excluding specific sectors altogether from the MAI disciplines. However, it must be noted that the possibility of future policy changes which could be provided for by the second schedule, would undermine the credibility gains from the MAI for developing countries.

It must be noted that nothing in the current MAI draft requires the parties to commit to any rollback obligations. In fact, any commitments towards the gradual elimination of existing non-conforming measures would be voluntarily made in the exceptions schedule. This contrasts sharply with the original purpose of the MAI. Evidently, the periodic revision of the country schedules would exert strong ‘peer pressure’ to dismantle non-conforming measures, but failure to do so would not breach the MAI.

X. Relationship to Other International Agreements

Obligations acquired by the parties under the Articles of Agreement of the IMF will not be affected by the MAI. This exception is of crucial importance for developing countries, because IMF’s policy conditionality can involve the adoption of temporary measures (such as capital controls or exchange restrictions) to overcome severe macroeconomic disequilibria, measures which would otherwise be inconsistent with the MAI.

The MAI also stresses the importance of the OECD Guidelines for Multinational Enterprises, but reaffirms their non-binding character.

XI. Implementation and Operation

Between the signature of the final act and the entry into force of the MAI there will be a Preparatory Group in charge of the negotiations with non-signatories and other pending issues. After the entry into force of the MAI, the Parties Group, in charge of the operation of the agreement, will be established. One important issue for developing countries, and one which has not yet been resolved, is the financing of the MAI and the Parties Group. In principle, the costs will be borne by all the parties, but the criteria for the apportionment will be crucial in facilitating developing country accession.

XII. Final Provisions

Accession

The MAI will be open for accession after its entry into force. The specific terms of accession and obligations thereby undertaken will be negotiated between the applicant country and the Parties Group. The latter will make the final decision, though it has not been decided whether by consensus or by (three-quarters or two thirds) majority. A contracting party may deny the applicability of the agreement between itself and any acceding party. The language so far used by the MAI provides flexibility for the case-by-case negotiation of accession conditions, which is very positive for acceding developing countries. However, it is likely that a ‘core’ of minimum provisions (for instance NT, MFN, and transparency) would be established as a necessary condition for entry.

Withdrawal

No contracting party will be allowed to notify withdrawal from the MAI before 5 years from accession (and withdrawal will be effective 6 months after notification). Moreover, the provisions of the MAI will still apply for 15 years after notification of withdrawal with respect to any existing foreign investment at that date. Effective locking-in is thereby guaranteed. Accession would thus require the developing countries to consider accession carefully, and to negotiate in detail their specific conditions and exceptions.

Denial of benefits
It is being negotiated whether a party will be allowed to deny benefits to an investor of another contracting party which is owned or controlled by investors from a non-contracting party. This provision might avoid that investors from third parties take advantage of the benefits of the agreement by channelling investments through non-operating holding companies incorporated in a contracting party. It might also avoid 'round trip' capital flows from domestic investors of a contracting party who want to benefit from increased protection (and even from available incentives) as foreign investors into their own economy - a common practice in developing countries.

4. A COMPARISON OF THE MAI WITH RELATED AGREEMENTS

Generic elements of international investment agreements

Regulatory policy - and commitments made in international agreements - should take account of investors' preferences for liberal and predictable rules in all aspects of their business. Effective agreements would need to go well beyond the limited scope of traditional bilateral agreements. Table 3.1 lists a number of criteria on the basis of which such agreements could be judged. Key substantive elements are investment liberalisation, protection and dispute settlement procedures. These then permit a comparison of the MAI with other agreements and an evaluation of the alternative forum provided by the World Trade Organisation (WTO).
International investment treaties are too numerous to summarise in this context - UNCTAD (1996a) has collated the key features of the main international investment treaties. The most important treaties are evaluated along the lines of some of the above criteria in UNCTAD (1996b). The following section will outline the main features of a number of agreements.

Table 3.1: Criteria contained in international investment agreements

Definition	what kind of assets are to be covered?	enterprises (control) asset-based (includes portfolio investments) non-FDI forms of assets, e.g. IPRs, capital goods
Coverage	what kind of practices and entities are to be covered?	sub-national measures state enterprises
		private restrictive business practices
Investment liberalization	promote and secure non-discriminatory treatment, restrict departures	transparency right of establishment/market access non-discrimination: natl treatment or MFN
		reservations and general exceptions
		TRIMs and other performance requirements
		movement of key personnel
		taxation
		rules of origin
		subsidies and investment incentives
		monopolies and concessions
Investment protection	legal certainty, protection from arbitrary measures	payments and transfers expropriation
Dispute settlement	crucial role of credible enforcement of commitments	state to state investor to state

Source: Adapted from SauvJ (1995).

Investment definition, liberalisation and protection

Bilateral Investment Treaties

Investment issues are a key element of the commercial relations between states. Among industrial countries, investment issues are settled under a number of (non-binding) OECD instruments. In the late 1960s, a number of European investor countries perceived a need to protect their assets in developing countries and started to adopt *bilateral investment treaties* (BITS)[29]. A dense web of about 1,600 bilateral treaties has been formed to date, covering all parts of the developing world.

These treaties focus solely on investment issues and make binding provisions on expropriation, compensation for losses due to armed conflict or internal disorder, and for the transfer of payments. Typically, these benefits are accorded on a national treatment or MFN basis. The definition of investment used is broad, covering both non-equity forms of investment and portfolio investment. Protection is only granted to investors with real links to one of the two partners to the agreement[30].

29 These treaties are called Investment Promotion Agreements in the UK.

30 In the case of the UK, only firms incorporated under UK law.

BITs also provide for the resolution of investor-state disputes in private institutions (the arbitration centres of the International Chamber of Commerce) and in the International Centre for the Settlement of Investment Disputes (ICSID) of the World Bank. However, in contrast to their specificity with respect to investment protection, BITs are short on commitments on the liberalisation of investment restrictions. National treatment rarely extends to the pre-entry phase (i.e. right of establishment) and few BITs contain provisions on investment restrictions, such as performance requirements.

Table 3.2: Regional distribution of bilateral investment treaties, 1994

	Asia & Pacific	Africa	Latin America	Central & eastern Europe	Total
Germany	15	36	8	12	86
France	11	17	8	11	55
UK	13	15	8	12	62
Netherlands	11	13	1	9	38
Japan	2	1	0	1	5
US	2	7	2	14[a]	29

[a] all of which were signed in 1992-4

Source: Sauvant and Aranda (1994) and UNCTAD (1994).

Regional Agreements on Trade and Investment

Attempts to co-ordinate investment policies between a larger group of countries have been most successful where countries are highly interdependent in their trade and investment flows. The EC's Treaty of Rome or the US Canada Free Trade Agreement of 1989 are examples of treaties among industrial countries that have recognised the complementarity between trade and investment. FDI *between* developing countries is small - although growing - and the investment provisions in regional trade agreements covering only these countries (such as Mercosur) are fairly rudimentary.

Regional trade agreements involving both industrialised and developing countries have responded the growing importance of the latter group as an investment location. Typically, these treaties include commitments on non-discriminatory treatment and investment restrictions. This appears to be easiest where one of the partners has a clearly dominant position in the region and is committed to a high standard liberalisation agreement. Investment provisions in the rather loose and diverse group of APEC countries are non-binding. Those in NAFTA or in the EU Association Agreements with eastern European countries, however, are binding and considered stringent. The investment provisions in the NAFTA treaty have been portrayed as the blueprint for the MAI and hence warrant closer analysis[31].

Investment provisions are contained in the NAFTA chapters on investment, on services and on financial services. All three chapters provide for national treatment. Where a signatory has lodged an exemption from these disciplines MFN will act as a minimum standard. In this case, the host country may discriminate in favour of national firms but must grant equal treatment to all foreign investors.

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31 Rugman and Gestrin (1995).

Conversely, where the host country government discriminates in favour of foreign firms, such preferential treatment will have to be extended to all foreign investors. NAFTA also bans a comprehensive list of performance requirements and thereby provides disciplines that go well beyond multilateral disciplines in GATT/WTO. Most performance requirements are also banned even if the investor agrees to comply with the restriction in return for accepting an investment incentive from the host country.

The dispute settlement mechanism in NAFTA is similarly innovative. Private investors and not just states have the right to bring cases for arbitration under either ICSID or UNCITRAL, the two international bodies for the settlement of investment disputes - creating the prospect of international investor-state claims.

To date the above provisions represent the strongest standard with regard to investment liberalisation and protection. Even though the Mexican government needed to liberalise its investment policies significantly to conform with the agreement it subsequently extended the substantive rights (Chapter 11:A) to investors from outside North America. Still, the agreement has been criticised for a number of shortcomings. Rules of origin could have a distorting effect on trade and investment flows. Disciplines on subsidies are weak and few provisions exist to deal with the competition aspects of inward investment in Mexico. Moreover, where parties were granted exemptions they are free to derogate from the above disciplines. This is the case for Mexican energy and transport sectors, Canadian cultural industries, maritime transport in the U.S. and for agriculture in all three parties.

NAFTA underscores the benefits of a comprehensive approach to trade and investment liberalisation. Provisions on intellectual property rights, services and technical standards all are integral elements of meaningful investment liberalisation. None the less, the lessons learned from NAFTA are not really applicable for a more comprehensive investment agreement in the developing world. The strong political interest of the U.S. in a treaty with Mexico and the previous liberalisation between the U.S. and Canada make this agreement unique. Moreover, preferential regional integration necessarily lead to distortions of trade and investment flows.

WTO Agreements on Investment and Services

Investment issues have a long, if inconclusive, history in GATT. Unlike the original draft for the ITO, GATT made no reference to investment issues. The only panel decision related to investment policies - on the Canadian Foreign Investment Review Act of 1984 - was clearly limited to the implications for goods trade. Recognising the limitations of GATT in this area, the panel decision clearly referred to the importance of active investment policies for developing countries.

Since then, developing countries have unilaterally liberalised their investment policies and consequently took a more constructive approach to U.S. efforts to adopt investment disciplines in the Uruguay Round. The TRIMs Agreement bans a limited number of performance requirements in as far as they are inconsistent with GATT provisions on national treatment and quantitative restrictions. All parties needed to notify and phase out contravening measures, though developing countries were granted generous transition periods (five years for less developed and seven years for least developed countries). This agreement has considerably enhanced the transparency of investment policies in the developing world but the list of measures falls well short of that in NAFTA. Moreover, the agreement is limited to measures affecting only trade in goods.

The services agreements (GATS) had a more far-reaching impact on investment policies in developing countries. Of the four ‘modes of supply’ covered by the agreement, the establishment of a commercial presence relates directly to investments in service sectors[32]. Most-favoured-nation treatment became a general obligation for which exemptions had to be notified before the Round's conclusion (Article II GATS). Market access and national treatment obligations, however, apply only to those sectors and modes of supply that have been put in the schedules of commitments submitted by the signatories (Articles XVI and XVII)[33]. Market access is defined by the prohibition of six categories of restrictions in Article XVI. Restrictions on the number of service providers, on the total value supplied or on the number of persons employed (that is the equivalent of quantitative restrictions) are the most notable form that have been prohibited[34]. Still, 'conditions and limitations' for both market access and national treatment could be entered in the schedules of commitments, again specific to sector and mode of supply. This 'positive list' approach of enumerating the specific sectors and modes of supply to be covered contrasts with the traditional GATT approach based on general principles. It was in part due to the administrative constraints faced by many developing countries which were unable to schedule specific exemptions to more comprehensive general obligations.

The GATS has made significant progress in service sector liberalisation in developing countries. However, service sector regulations have only become transparent to the extent that specific commitment were made; all other sectors remain outside the purview of GATS. Even where such commitments were made, these are still subject to significant regulatory discretion[35]. Often countries reserved their right to impose authorisation or screening procedures on investments and these conditions could give rise to numerous complaints under the dispute settlement mechanism. Finally, the scheduling of commitments by modes of supply has led to the somewhat paradoxical result that most concessions by developing countries were made under the commercial establishment heading. This mode is seen to create the most benefits for the domestic economy; the uncertainty surrounding the other modes will leave service providers little choice but to establish in order to gain market access.

A key point to note is that WTO members already have an obligation to treat foreign service providers on an MFN basis. Art II:1 GATS extends the MFN obligation to all 'measures by Members affecting trade in services'. The MAI will not constitute a regional agreement under WTO law within which signatories could have extended MFN treatment on a *conditional* basis. For this reason, countries negotiating the MAI had little incentive to make service sector concessions that go beyond those already granted under GATS[36].

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[32] The other modes of supply are the temporary movement of individual supplying services, the movement of the service consumer to the country of the supplier and the cross-border supply of services. Restrictions imposed on these kinds of interaction have of course implications for the relative attractiveness of establishment trade.

[33] The GATS introduced the concept of de factor national treatment in Art.XVII. In some service industries identical treatment could actually put foreign firms at a competitive disadvantage. In these cases different laws can be applied to domestic and foreign enterprises provided their competitive positions remain equivalent.

[34] Article XVI:2 GATS

[35] GATS only covered about 50% of service sectors in high income countries and about 11% in developing countries. Unconditional concessions amounted only to 28% and 6.5% respectively; see Hoekman and Sauve (1995) for details. The agreement was subsequently expanded in sector-specific negotiations such as telecommunications and financial services.

[36] Wimmer (1996)

Two other Uruguay Round agreements also had important implications for investment policies in developing countries. The agreement on trade-related aspects of intellectual property rights (TRIPs) provides further protection for intangible assets that form the basis of the activities of MNCs. The agreement stipulates the minimum standards for the protection of IPRs that were already set by other international organisations, such as the World Intellectual Property Organisation. It further requires that member countries provide effective legal procedures and remedies for the enforcement of such rights. Secondly, the subsidies agreement has had an impact on some of the incentives with which LDCs compete for inward investment. Subsidies to investors that are granted on the condition of meeting certain export performance standards belong to the so-called 'red box' of prohibited subsidies[37]. Countries that are classified as least developed, however, are exempted from prohibiting subsidies contingent on export performance and from those contingent on domestic content.

Dispute Settlement Procedures

The impact of international rules on the conduct of governments hinges on the efficacy of dispute settlement procedures and enforcement mechanisms. Since the 1960s several bilateral and regional treaties have therefore referred to the International Centre for the Settlement of Investment Disputes (ICSID) which was established in 1965 as a subsidiary of the World Bank Group. This was considered a notable achievement as the Centre provided private investors with an independent arbitration panel. At the time, Latin American countries increasingly applied the so-called *Calvo Doctrine* which denied foreign nationals home country protection and bound them to settle claims under domestic laws and institutions. Since 1966, 26 disputes have been submitted to the ICSID, and eight of these ended with awards on the merits of the cases. Although the ICSID has no power to enforce its decisions, it is regarded as an incentive for the amicable resolution of disputes. Similar functions could be performed by the United Nations Commission on International Trade Law (UNCITRAL).

These dispute settlement procedures differ sharply from those in the WTO. As in most investment disputes WTO members first have to attempt consultation and mediation. Where this fails the Dispute Settlement Understanding (DSU) provides for the establishment of a panel. This panel cannot arbitrate the dispute but, where it finds that the actions of the defendant violated WTO obligations, it will recommend remedial action. If - after a possible appeal - the Dispute Settlement Body (all WTO members) does not decide by unanimity to block the adoption of the report the defendant party will have to comply with its recommendations. If the defendant party does not take the recommended action after a reasonable time, the aggrieved party is free to request compensation and in the final instance 'retaliatory' action.

Hence, in the last resort violations of GATS, the TRIMs or TRIPs agreements may be punished by withdrawing trade concessions in the trade field (and vice versa). This integrated dispute settlement mechanism is regarded as the essential enforcement mechanism for all the above investment provisions. Two features make it particularly effective: the possibility of several large parties taking action could enhance the severity of retaliatory action and the possibility of taking withdrawing concessions in

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[37] Article 6.3(b) of the Agreement on Subsidies and Countervailing Measures states that a serious prejudice will arise from a subsidy if 'the effect of the subsidy is to displace or impede the exports of like product of another Member from a third country market'. Hence under Article 5 and 7 of the agreement fiscal incentives granted in return for compliance with export performance requirements would be subject to remedies by injured third parties.

unrelated fields (‘cross-retaliation’) discourages deviant behaviour. Still, in practice this system is asymmetric as it depends on market size and economic interdependence.

Is the MAI an agreement of the ’highest standard’?

Negotiations on the MAI began in 1995 in the hope of achieving the adoption of a high standard of investment protection and liberalisation among ’like-minded’ OECD countries. If developing countries accede to the agreement they will logically need to make sure that the MAI is as effective as other international investment agreements in enhancing investor confidence. Moreover, the MAI will need to be compatible with obligations which LDCs entered into under earlier agreements, in particular in the WTO. It is questionable whether the MAI in its present form meets either of these criteria. This section will compare the draft MAI to other agreements on the basis of the criteria set out in UNCTAD’s (1996) comparison of previous investment agreements: coverage of the agreement, standards of non-discrimination, investment restrictions and incentives, investment protection, transparency of rules, dispute settlement mechanism and ’broader concerns’.

As explained in Section 3 above, the MAI will be a legally binding agreement that will cover a broad range of investments, including portfolio investment, contractual rights and intellectual property[38]. This mirrors the *coverage* of investment in NAFTA and exceeds the coverage in most other bilateral and regional agreements. A broad definition of FDI reflects the recognition that comprehensive investment protection covers all assets related to the activities of a foreign affiliate.

The wording of the obligations for *national treatment* or for MFN treatment (whichever is better) closely mirrors similar clauses in other investment agreements. The bracketed clause on ‘like circumstances’ corresponds to the wording in NAFTA Art. 1102 or GATS Art. XVII: the treatment of foreign firms could be materially different from that of national firms if the situation of foreign firms is not comparable, as is the case in many service industries[39]. This obligation for national treatment covers both the pre-entry phase and existing establishments, hence amounts to a right of establishment. The national treatment provision in the MAI goes well beyond most bilateral and regional investment agreements, in which national treatment is only granted for existing establishments. The scope of the provision in the MAI will however depend on the number of exemptions which Signatories lodge under Section IX Annexes A and B - it is expected that they will considerably weaken obligations for non-discriminatory treatment.

Annex A will ’grandfather’ existing non-conforming measures and in Annex B parties will be free to lodge additional sector-specific exemptions from the general obligations. It is unclear to what extent acceding LDCs will have similar rights to deviate from general obligations. In any case, the provisions on non-discrimination together with the list of exemptions are potentially incompatible with obligations under the WTO Services Agreement (GATS). Under this agreement, each WTO member scheduled specific commitments regarding national treatment of the commercial establishment mode. Sectors for which WTO Member have not scheduled commitments might still be subject to the more general obligation for MFN treatment.

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38 Multilateral Agreement on Investment: Consolidated Text, draft of 12 Feb.98 (hereafter MAI Draft)p.11

39 GATS Art XVII:2 and 3.

The text also includes provisions for *transparency*[40]. GATT Art. X requires similar disclosure of all relevant national provisions and TRIMs Agreement Art. 6 and GATS Art. III stipulate notification requirements for investment rules. The obligation to disclose all relevant national investment regulations will enhance investor confidence in the regulatory environment in developing countries.

The list of banned *performance requirements* in the MAI goes well beyond those in the TRIMs Agreement or in Art. 1106 of NAFTA[41]. However, in developing countries it is common practice to tie investment incentives to the compliance with performance requirements. The present MAI text does not prohibit this linkage and thereby falls short of provisions in NAFTA Art. 1106 (3) and in the TRIMs Agreement.[42] Moreover, in contrast to the TRIMs Agreement, the list in the MAI is closed and hence allows national governments to impose additional restrictions not covered by the agreement.

More generally, there appears to be no consensus on the treatment of *incentives*. This is a serious shortcoming and will leave the increasing subsidy race between developing countries unchecked. Incentives represent a key instrument of industrial policy in developing countries. The MAI is focussed on investment issues and is hence unlikely to take up such broader issues of subsidies policies.

The MAI protects the *transfer of funds* by foreign-owned affiliates into and out of the host economy.[43] Such transactions are a key concern for developing countries in times of balance of payments crises and the MAI acknowledges that intervention by central banks in pursuit of monetary and exchange rate stability or under obligations of the IMF take precedence.[44] The coverage and the safeguards for this article appear to be in line with bilateral and regional agreements.

Finally, the *dispute settlement* mechanism has been praised as one of the major achievements in the MAI. The MAI's state-to-state and investor-to-state procedures are said to represent the most advanced dispute settlement procedures. Similar procedures have so far only been adopted in chapter 11:B of NAFTA and in the European Energy Charter. However, the MAI again risks incompatibility with current and future WTO procedures. WTO provisions bind governments who are the only parties with rights of legal standing in dispute settlement proceedings. Even though private rights of litigation might be desirable, WTO proceedings are unlikely to accommodate this. Provisions under the WTO Dispute Settlement Understanding (DSU) also appear more effective in inducing compliance with current and future investment provisions. Where a defendant party fails to comply with the recommendations of a dispute settlement panel the complainant will be authorised to withdraw a commensurate amount of concessions granted to this member.[45] This possibility of cross-retaliation - and the possibility of several aggrieved parties taking concerted action - appears a more effective discipline on non-compliant behaviour. In the MAI, suspension of concessions under the agreement will only be effective in the hands of significant host countries. Monetary damages could be awarded in the investor-to-state proceedings but might be difficult to establish where the loss is not easily quantifiable.

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40 MAI Draft, p.13-14

41 MAI draft text, at pp.18-20.

42 The GATT Agreement on Subsidies and Countervailing Measures could also be construed to make such incentives actionable under Art.5 and 7.

43 MAI Draft p.54

44 MAI Draft, p.73 and p..93

45 DSU Art. 22.3 (c).

The MAI also takes up a number of *broader concerns*. Labour and environmental provisions are yet to be agreed, as we have seen. The section on 'Monopolies, State Enterprises and Concession' attempts to deal with the competition implications of a liberal investment regime.[46] The interaction between inward investment and market structure was recognised in the services negotiations of the Uruguay Round. GATS Art. VIII stipulates that monopolies and exclusive service suppliers shall not act in a manner inconsistent with members' obligations under the Agreement; while Art. IX provides for consultations over restrictive business practices. In the WTO Telecommunications Agreement these articles were implemented when WTO members entered into specific competition safeguards. The competition section in the MAI draft is still heavily footnoted and despite long-standing OECD work in this area a number of contradictory proposals expose wide differences in opinion.

The failure to agree on competition provisions in the MAI points to a more fundamental deficiency. An exclusionary focus on investment is at odds with the nature of FDI. Foreign investment will give rise to the full set of issues of modern trade relations which are already addressed in WTO agreements. In this sense, the OECD might be the wrong forum to address the multi-faceted issues at the interface of trade and investment policies.

The WTO working group and prospects for investment provisions in the WTO

Could the WTO provide an alternative forum for a multilateral investment agreement? Given the recent adoption of investment provisions in the Uruguay Round, the WTO has since made rapid progress on this subject. A working group on trade and investment was established under the Singapore Declaration in 1996 and first met in June 1997. The work programme adopted at the first meeting lists the impact of investment on economic development as a key concern, which has been similarly highlighted by both industrialising countries (India, Brazil, ASEAN) and by large industrial countries (EU, Canada, Japan).[47] Least developed countries stress the 'educational' purpose of this undertaking and highlight the analytical work which they regard as a prerequisite for future negotiations. However, in part as a result of earlier *unilateral* investment liberalisation, developing countries now take a much more constructive approach in these talks. After settling other agenda items, such as a stocktaking of existing agreements or the study of the interrelationship between investment and trade, the group will discuss a possible negotiating agenda. A decision on possible WTO negotiations is likely to be taken at the 1999 WTO Ministerial.

This decision clearly depends to a considerable extent on the outcome of the current MAI negotiations. However, in recent months there have been repeated calls for a reassessment of the role of the WTO in complementing - or even substituting for - the investment provisions in the MAI. Clearly there is a trade-off between the broader representation in this forum and the time involved in arriving at tangible results. However, three points are worth noting:

> A limited number of countries willing to commit themselves to high standards of investment protection are free to adopt such standards swiftly within the WTO framework. Annex IV to the Agreement establishing the WTO provides for such plurilateral agreements. The Subsidies Code

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46 MAI draft, pp. 30-40.

47 *Inside U.S. Trade*, 6 June 1997

represents an important precedent in which a plurilateral agreement was subsequently adopted as a core part of GATT obligations.

The WTO provides a natural forum to negotiate issues related to FDI (competition issues, intellectual property rights, trade issues) which are already part of existing provisions or of a future agenda. Lack of adequate instruments to deal with these issues is a key obstacle to agreement in the OECD.

Developing countries will be free to negotiate 'special and differential treatment' in any WTO provisions. Lengthy transition periods as well as special exemptions are part of the concessions made to developing countries during the Uruguay Round and have a long history in GATT.[48] Explicit transition arrangements are absent from the MAI. Although these transition provisions do help poor countries adjust to international standards by containing social costs and allowing domestic firms to reorganise, they can have a negative economic effect if too prolonged. Thus any such transition arrangements that might be put into the MAI should be designed in a way to avoid further distortions of investment flows.

5. THE DEVELOPMENT IMPLICATIONS OF THE MAI

What are the Advantages for Developing Countries of an International Investment Agreement?

As was pointed out in Section 2, the process of financial globalisation (and in particular the liberalisation of capital flows) has accelerated over the last decade and is clearly set to continue under foreseeable circumstances. From the point of view of developing countries, therefore, the issue is how best to adapt to and take advantage of this trend rather than to attempt an independent development path. In this context, a multilateral regulatory framework for investment potentially has much to offer developing countries. Benefits include not only increasing the flow and stability of foreign investment, but also substituting for weak domestic institutions. These would be realized so long as the MAI - or another similar multilateral agreement - makes specific allowance for the particular conditions they face and is accompanied by international assistance to bring them up to the required regulatory standard.

Investment protection provisions are of particular importance for developing countries characterised by weak institutions or political and economic instability, as they allow these countries to 'import' conditions of increased certainty, credibility, transparency and stability under a multilateral framework. They also allow developing countries to import the international regulatory 'best practice' and thus strengthen their own domestic institutional capabilities and disciplines.

The exclusive provision of international protection to foreign investment reduces the risk premium for foreign investors of local investment opportunities relative to that for domestic investors. This arises because the MAI guarantees fair and equitable treatment for foreign investors, while local legislation may

[48] As early as 1954 the original GATT text was modified to allow for quantitative restrictions in cases of perceived balance of payments crises. The vague nature of requirements has led to the widespread abuse of Article XVIIIb by developing countries. In the 1960s the continuing discussion of a 'new international economic order' and the set-up of UNCTAD as a rival institution risked a fragmentation of the world trading system. GATT negotiators responded by adopting Part IV of GATT, thereby exempting LDCs from reciprocity in trade negotiations, and essentially allowing them to free-ride on the concession made by others (MFN principle). The Tokyo Round agreement of 1979 adopted the so-called Enabling Clause which authorises tariff preferences under the Generalised System of Preferences (GSP) invoked by the US, Australia and Japan; the EC had already adopted Lome Convention.

not do this for domestic investors. In environments otherwise impaired by large uncertainties, especially those of the poorest developing countries, this may result in some degree of crowding out of domestic investment by foreign investment, and may stimulate capital flight and 'round-trip' flows.[49] To avoid the resulting investment diversion and resource misallocation effects, some developing countries might wish to have the investment protection regime extended to domestic investors - although the implications of this may be considerable.

In the absence of multilateral, regional or bilateral agreements, investor-to-state disputes are usually dealt with in the courts of the host countries. This very fact deters many investors from moving into the poorer developing countries, which may not have developed legal rules and/or independent, reliable courts. The most important advantage that the MAI provides to investors concerning the settlement of disputes, is thus the provision of direct international investor-to-state mechanisms. Although contracting parties cannot submit claims against foreign investors to the international arbitration tribunals provided for in the MAI, this does not necessarily represent an asymmetry because they may do so in domestic courts.

In other words, the impact on developing countries of membership of the MAI would depends to a considerable extent on the quality of their own domestic legal systems.

None the less, our examination of other international agreements indicates that the MAI may not in fact be of 'the highest standard' as intended, because it does not provide for ongoing liberalisation in way that regional arrangements such as NAFTA do. The absence of any binding roll-back obligation mean that a wide range of exemptions may persist indefinitely. Moreover, the MAI will overlap - and possibly be incompatible with - a number of other international agreements of interest to developing countries, as we have seen in Section 4.

What are the Advantages of Joining the MAI?

The current draft of the Multilateral Agreement on Investment (MAI) represents the rationalisation of existing arrangements between OECD members - many of them bilateral in nature - with voluntary accession for other countries. Its more advanced features are based on the North American Free Trade Agreement (NAFTA), which itself involved a developing -country partner (Mexico) as well as one with particular structural vulnerabilities (Canada), and thus contains considerable flexibility. In consequence, it might appear at first sight that if individual developing countries find the MAI inappropriate, then they can simply not seek accession. This would in any case be consistent with the current expectation that beyond the original twenty-nine[50] negotiating parties, only a limited number of middle-income industrialising countries would be expected to request accession during the first decade of the next century.

However, this simple conclusion is unwarranted. On the one hand, the MAI once implemented would become the 'floor' for bilateral agreements and a benchmark for plurilateral agreement which developing countries might enter, and would thus reduce the degree of flexibility inherent in existing arrangements which can be adapted to particular countries' circumstances. On the other hand, the accession of a significant number of developing countries would leave non-members in a very disadvantageous position when attracting foreign investment. This might lead to a situation where non-members are forced - or feel themselves to be forced - to lower standards and raise incentives in order to encourage firms whose

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[49] Where funds are exported and then brought back as foreign investment inflows.

[50] The 28 members of the OECD plus the EU

international competitiveness depends on resource predation, labour exploitation or corrupt practices rather than high productivity and modern management. The risk of adverse selection of FDI inflows to non-acceding countries would thus be increased.

In contrast, there are considerable advantages to foreign, domestic and expatriate investors of ‘locking in’ a developing country to an international regulatory regime, in terms of reduced uncertainty leading to more and better investment. There would be additional benefits of ‘formalising’ trans-border relationships with firms, particularly in combating fraudulent firms, corrupt concessions, money laundering and tax evasion. However, poor countries have special problems in terms of strength of public institutions and private enterprise which must be addressed in practice. These differences in interests and capabilities are clearly greater among small LICs than for larger LICs or MICs. The particular forms of vulnerability of the small and/or poor countries who stand to gain most from such recognition should thus be addressed in any international investment regime.

The transparency requirements in the MAI are such as to strengthen market institutions in developing countries, as will the dispute settlement procedures; but both could be very costly for poor countries. However, the restrictions in the MAI on performance requirements and other controls do not constitute a serious disadvantage for developing countries, and there is a wide margin for exceptions.

The advantages of investor protection mechanisms in the MAI are primarily conceived in terms of increasing the credibility of government commitments, which then encourages foreign firms to undertake long-term fixed investments from which they cannot easily withdraw. In the case of developing countries, the existence of such a commitment to foreign firms also enhances the security of domestic investors who hold their capital abroad (or may even be non-resident) encouraging them to repatriate these funds.

A Potential Loss of Political and Economic Sovereignty?

Some developing country governments and non-governmental organisations are concerned that the MAI will involve a loss of economic sovereignty, and thus prevent the pursuit of sustainable development strategies.

The current draft text of the MAI does not contain explicit development objectives, but the scope and application provisions of the MAI - which define investors and investment - are appropriate in principle as they do no more than attribute the same treatment to foreigners as to domestic investors. However, in many developing countries there are key sectors (such as mining) where large foreign firms have no domestic equivalents, which makes this concept somewhat ambiguous.

All multilateral agreements involve some pooling of sovereignty. The relevant issue is whether the economic gains exceed the ‘option value’ of the sovereignty pooled - that is, the value of policy options precluded by belonging to the agreement. In our opinion, developing countries will gain significantly by becoming part of a rules-based international system that will allow them not only to attract foreign investment, but also to regulate foreign firms more effectively.

The economic gains from MAI membership for developing countries would be achieved even if they do not form part of the negotiating group. However, the domestic political legitimacy of such an arrangement would always be in doubt. Moreover, the same economic gains could be achieved from a WTO-based multilateral investment agreement, which would combine a maximum of sovereignty with all the benefits from MAI.

Trade protection for domestic producers is in any case constrained by existing WTO agreements arising from the Uruguay Round; so it is not available as an instrument of policy to the extent that it was in the traditional 'import substitution' model. Similarly, almost all developing countries are already engaged in privatisation programmes, and the nationalisation of foreign enterprises no longer forms a part of any development strategy. In consequence, the MAI provisions on expropriation do not represent a real constraint on sovereignty - particularly since public interest objectives allow for expropriations so long as these are not discriminatory.

Never the less, it would still be possible for governments to impose across-the-board restrictions on investment under the MAI, so long as they apply to both domestic and foreign investors. Hence, the MAI will not substantially affect the domestic regulatory environment. This may be positive for countries where the levels of institutional development and investment climate are reasonable by international standards, although it may be of little help to the LICs unless they receive considerable international support in order to reform and strengthen their domestic legislation and regulatory institutions.

Would an Independent Financial Policy still be Possible?

The loss of sovereignty in the conduct of economic policy appears to be minimal or non-existent under the MAI, on the assumption that the feasible range of policy options are all based on making markets work effectively rather than replacing the market with the state. However, concern has been expressed that accession prevent developing countries from conducting an independent macroeconomic and financial policy in the interests of its own citizens. As the World Bank points out, 'developing countries need to build better shock absorbers and develop mechanisms to respond to instability because they will remain highly vulnerable to economic disturbances for some time'.[51]

Monetary and debt-negotiation issues are explicitly excluded from the MAI. The provision of education, health and infrastructure - which may well be the best way to attract foreign investment - is not considered at all. It is of course true that developing countries would still be restricted in these matters by agreements arising from membership of the IMF or subsequent loan conditions. However, this issue is one of reforming international financial institutions rather than attempting to modify the MAI in order to over-ride their loan conditions.

Capital account liberalisation tends to generate greater volatility in capital flows for developing countries, whose macroeconomic policy stance is increasingly determined by changes on international financial markets.[52] Thus the MAI itself, by contributing to the sudden liberalisation of the capital account of the balance of payments, may create greater volatility as well as larger average inflows. The financial sector in developing countries is often weak, as the recent Asian financial turmoil has shown, due to both the structure of the market itself and the lack of adequate regulation.

Given that borrowers in developing countries (particularly LICs) are credit rationed in the international and domestic capital markets, liberalisation of cross-border financial sector investment would be beneficial. However, the development of competent regulatory bodies (lacking in most LICs) should precede financial liberalisation.[53] In this respect, the 'prudential measures' exception to the application of

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51 World Bank (1997b), p.7

52 FitzGerald (1996)

53 World Bank (1997b)

the MAI may not be sufficient. Developing countries without adequate financial regulation infrastructure and capabilities will probably need specific exceptions and transitional arrangements, regarding this sector, when acceding to the MAI.

General Exceptions

The provisions for general exceptions are of crucial significance to the eventual accession of developing countries to the MAI. The general exceptions would allow countries afflicted by military or civil conflict to remain within the Agreement.[54] More importantly, they would allow developing countries to suspend whichever provision of the MAI is believed to seriously affect public order - identified in the text as being the protection of 'the fundamental interest of society'.[55] This could be highly relevant to developing countries affected by social or military conflict in neighbouring countries. It would also provide a means of shielding the economy from major external trade or financial shocks transmitted from the world economy or affecting a region as a whole.[56]

Technology Transfer and Performance Requirements

The performance requirement provisions of the MAI are not as far reaching or as negative as some commentators have claimed. Overall, the impact on developing countries, many of which have already embarked on the unilateral abolition of restrictions to foreign investment, are likely to be positive. Moreover, empirical evidence suggests that enlarging the technical and managerial skills of the domestic labour force is not only a necessary but also perhaps the most cost effective way to ensure technology transfer. In specific cases, developing countries may wish to maintain (through exceptions or reservations) some performance requirements on the grounds of public interest, but these should be specified in a negative list, and be made consistent with the NT and MFN (i.e. non-discrimination) clauses.

Discriminating against low-tech foreign investment through technology transfer or R&D requirements at the entry, establishment and/or expansion levels does not in itself attract hi-tech investment. It may instead distort the allocation of resources and prevent host countries from reaping the wider advantages from international investment. Furthermore, technology is difficult to define and even more difficult (and burdensome) to screen, especially when it comes to 'soft technologies' such as ideas, information, management and organisational skills. Therefore, the derogation of technology transfer requirements as barriers to foreign investment entry should not be a problem for developing countries.

None the less, it would probably be desirable for broad criteria to be established for the regulation of foreign investment in strategic sectors of small countries. The microeconomic decisions of firms in key sectors of small economies such as mining and tourism can have major macroeconomic consequences through their effect on sub-contracting, employment, exports and tax revenue, and thus justify the existence of national criteria. There is also an evident need for broad exceptions to allow incentives to be extended to particular types of firms - particularly small enterprises and co-operatives - for social reasons,

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[54] Although it is doubtful whether countries with persistent conflicts of these types would be admitted in the first place.

[55] The exact meaning of this term would be established by case law. However, the comparative public law literature identifies the 'core' elements of public order as: the protection of property rights; public health and safety; and, more recently, the environment.

[56] In other words, 'contagion'.

which could not be extended to foreign investors. In the present MAI draft, such exceptions could be accommodated on an ad-hoc basis, but they would be better specified as general principles for all developing countries, in order to avoid lobbying by particular multinational firms prominent in these sectors.

Labour and Environmental Standards
Regarding commitments not to lower standards, it might appear to be in the long-term interest of the citizens of developing countries that *at least* the stronger provision in the current draft (see Section 3 above) be approved.

We gather that a fresh 'package of proposals for text on environment and labour' is currently before the negotiators. While containing the same preambular commitments discussed above, it apparently suggests that contracting parties should agree not to lower their *domestic* health, safety, environmental or other labour measures as an encouragement to foreign investment. This would mean that any such lowering of standards would be considered non-conforming with the MAI and subject to dispute settlement challenge.

However, we recognise that in most developing countries (particularly the LICs), domestic health, environmental and labour standards may already be too low and largely un-enforced, or simply non-existent. Therefore, the relevant issue from a development perspective is whether the MAI - or any multilateral agreement on investment, for that matter - should also, in addition to prohibiting the lowering of existing standards, incorporate *universal* environmental and labour standards[57] and make them legally binding among signatories

Compliance with such higher standards would in fact mean greater changes for *local* firms than for MNCs if the principle of non-discrimination were to be applied in practice. But to do so would require a massive advance in human development. The developed countries are unlikely to be prepared to donate the necessary resources; so it would be inconsistent for them to insist that such standards be observed as a condition for effective participation by developing countries in international capital markets.

In consequence, under the current package developing country members of the MAI would be continually exposed to contentious disputes from competitors, and thus could not contemplate accession except under a general exemption from these conditions.[58] Indeed the real problem may be a quite different one. If a government does lower environmental or labour standards in order to attract foreign investment, the affected parties (industrial workers, indigenous groups etc) would not be able to bring the issue to court unless the corresponding constitutional provisions exist in domestic legislation.

Finally, environmental destruction has highly negative external effects which spread across borders. Poor labour standards can stimulate immigration flows towards developing countries. It is not, therefore, in the developed countries longer-term interest to exclude developing countries from the MAI if this would generate externalities arising from the lower labour and environmental standards in order to attract low-quality foreign investment.

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[57] For instance, those established in the Rio Declaration, regarding the environment, and those set forth in ILO's Tripartite Declaration of Principles concerning Multinational enterprises and Social Policy, with respect to labour standards.

[58] The formal request for exemption would presumably be politically unacceptable at home and diplomatically embarrassing abroad.

International Fiscal and Financial Arrangements
Some developing countries - particularly the smaller ones - might wish to pursue foreign investment incentive policies in an attempt to compensate for local distortions and inefficiencies, or to simply prevent foreign investment from going to neighbouring or similar countries. However, the empirical evidence suggests that incentives play a very limited role as determinants of foreign investment (see UNCTAD, 1995); and even where successful, involve significant fiscal costs. [59]

It is unlikely that an agreement on investment incentives between OECD countries will be reached in the present negotiations. The consequences for developing countries are serious because a multilateral co-ordination of investment incentive policies may help developing countries in terms of conserving fiscal resources and avoiding economic distortions.[60]

The MAI fails to tackle the single most important aspect of international investment taxation, the avoidance of double taxation.[61] Since the tax systems of the major home countries are based on world-wide income taxation principles, their multinational companies are frequently subject to some degree of double taxation. This fact not only deters international investment, but also provides incentives for the use of tax havens to channel cross-border capital flows (through the incorporation of offshore holding companies). The use of these schemes is detrimental to the home country, but it also affects recipient countries through both reduced tax revenues and through distorted investment inflows.

Most developed countries have entered into bilateral tax agreements among themselves, but unfortunately not with many developing countries. Only when a multilateral tax agreement (possibly based on the model treaty proposed by the OECD) is implemented, would the legal framework of international investment be complete. Such an agreement would not only improve the fiscal revenue position of developing countries and reduce the attractiveness of tax incentives to foreign investors, but would also strengthen the effort to combat money laundering and financial fraud.[62]

The existence of a large international public debt overhang in a considerable number of the poorer developing countries represents a major constraint on further foreign investment on any significant scale - due to the uncertainty caused by the prospect of severe stabilization measures in order to meet debt service, or the sovereign risk inherent in debt default. In fact, most of this outstanding long-term debt is now held by the governments of OECD countries or the international financial institutions which represent them; a fact which is implicitly recognised in the HIPC ('highly indebted poor countries') initiative for partial debt write-down and restructuring. If the LICs are to accede to the MAI or any similar agreement, it would seem to be essential that the outstanding debt is written off definitively.

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59 This fact is explicitly acknowledged in the article of the MAI referring to investment incentives.

60 In theory, disciplines on investment incentives might divert, at the margin, some foreign investment to non-signatories. However, the additional flows to non-members thus generated would be small (and the costs could far exceed the benefits) once the signalling and uncertainty-reducing benefits of the MAI for signatories are considered.

61 It only includes a political declaration in a footnote as to the desire of the parties to conclude agreements to that end.

62 "International co-operation between regulators and adequate disclosure of information at all levels are increasingly important to ensuring safe and efficient markets." World Bank (1997b), p.8.

Assistance to Help Poor Countries Meet Accession Requirements
From the above considerations it should be clear that developing countries - and the smaller low-income countries in particular - would require considerable assistance if they are to accede to the MAI or any other agreement of this type. Wide and semi-permanent exceptions are not the solution, because these would undermine the very rigour which creates confidence among investors. The issue is thus one of raising domestic standards rather than lowering international requirements.

Such strengthening of domestic standards is a complex, lengthy and expensive undertaking. However, it could bring considerable benefits for foreign as well as domestic firms. In particular, it would involve an overhaul of the system of commercial law - including the courts - and a parallel rationalisation of systems of public registries, accountancy systems, and government regulation. The role of aid donors could be crucial in this regard - providing not just financial support but, more importantly, technical expertise.

The proposed dispute settlement procedures would be involved and lengthy. Moreover, they could become endless because there is no explicit limit to the number of times an arbitration award may be challenged. The costs of representation and probably the costs of the tribunal will have to be borne by each party. These costs are usually very high, and barely affordable for the poorer developing countries. Moreover, most LICs lack the skilled litigants with expertise in international investment and arbitration procedures; which may call for the provision of internationally funded arbitration tribunals and pools of experts in this field.

Finally, the resolution of double taxation and debt overhang problems will also require a major effort from aid donors. Developing countries need help to strengthen
their own administrative systems in order to make a double taxation arrangements work. This help includes not only technical assistance and material resources to enhance their own tax administrations but also the sharing of information and above all the willingness to sign double taxation agreements with developing countries. The implication of this change in approach would be that developed countries would have to inspect the external transactions in developing countries of their residents with diligence, including the monitoring of transfer pricing and internal debt within multinational corporations. It would also imply that OECD countries would have to cease their tacit support for tax havens, whether under their own jurisdiction or used by their residents.

The current HIPC initiative[63] is limited to a small number of high-performance poor countries and would only involve the writing off of a small part of the debt overhang - the outstanding multilateral debt being fundamentally unchanged while the bilateral debt is forgiven. This debt overhang is a major disincentive to private foreign investors, due to the uncertainty it causes. A much more ambitious effort than the HIPC to write off the outstanding bilateral and multilateral debt of poor countries could be linked to accession to the MAI.

The Accession of the country in question would guarantee *future* private debt and would itself would constitute a form of conditionality more conducive to private sector development than the present systems operated by the IMF and other international financial institutions. It would also avoid the perceived problem of 'moral hazard' where countries might revert to irresponsible macroeconomic policies if the debt burden - and thus exogenous financial conditionality - were to be lifted.

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[63] See DAC (1998), World Bank (1997a)

Without such support, mainly from the OECD members which make up the DAC, it is hard to see how the poorer developing countries could hope to accede to the MAI. In our opinion, responsible DAC members can not logically support the MAI unless they are prepared to *either* provide the support needed by poor countries to accede - albeit in some special status - *or* to make special separate arrangements (which would also require support) for those countries unable to accede.

6. RECOMMENDATIONS

On the Multilateral Agreement on Investment
The development impact of MAI on poor countries could be positive if special provision for their accession is made, as set out in Sections 3 and 5. There is sufficient flexibility in the existing proposal to accommodate developing country interests. De facto exclusion may lead to negative effects such as loss of productive investment and a risk of competitive lowering of legal, fiscal, labour and environmental safeguards.

On Associate Status for Developing Countries
We do not consider separate ‘associate status’ for developing countries to be meaningful or useful. Rather we recommend full membership of the MAI for developing countries. Such membership could cover the core principles of the MAI by signatories (investor treatment and dispute settlement) combined with generic transition arrangements as well as specific exemptions of the kind set out in Section 5.

On the Negotiation Process
If agreement on broad-based accession turns out not to be feasible during 1998 due to a lack of consensus among OECD members, then the pursuit of a multilateral investment agreement in the wider forum of the 1999 WTO Ministerial would probably be advantageous for the reasons set out in Section 4.

On Environmental and Labour Standards
The treatment of environmental standards in the preamble to the MAI contains an adequate commitment to international norms and should be acceptable. The proposed inclusion of binding labour standards, although perhaps desirable in a general sense, may not be feasible in practice for developing countries and would effectively prevent their accession. Our arguments are set out in Section 5.

On Development Co-operation
The role of aid donors in supporting the accession of developing countries - and the arrangements and negotiations required - would be crucial, if the interests of the developing countries in general, and those of poor and vulnerable social groups in particular, are to be secured. This would imply both direct technical support to strengthen the negotiating, regulatory and legal capacity of developing countries. Only in this way would poor countries be able to take part effectively in an international investment system, for reasons set out in Sections 3 and 5.

On International Taxation and Debt
As an essential complement to the MAI, multilateral tax agreements based on the model treaty proposed by the OECD should be established between existing members and acceding developing countries. This is

necessary in order to ensure an equitable distribution of the fiscal resources arising from foreign investment. The HIPC initiative for debt relief should be deepened and linked to MAI accession, restoring debt solvency to acceding developing countries and increasing investor confidence without lowering policy commitments.

On Research Needs

Further work is required on the design of generic transition arrangements for developing countries, and on the necessary domestic legislative reforms required; which would involve case studies of a number of representative countries. A study is also needed of the development implications of a comprehensive multilateral investment agreement (MIA) under the auspices of the WTO. Research on the broader relationship between poor countries and international capital markets, including the consequences for poverty reduction, should also be commissioned.

On Public Consultation

The delays in the negotiation process have created an opportunity to undertake a broad consultative process on the MAI and international investment agreements generally. Broad consultations should be organised with all affected parties - including developing country governments, multinational firms and non-governmental organisations.

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Annex

MULTILATERAL AGREEMENT ON INVESTMENT (MAI): TERMS OF REFERENCE FOR A DESK STUDY OF THE IMPACT ON DEVELOPING COUNTRIES

PURPOSE

*The **purpose** of the study is to enable the UK to take an informed view of policy options towards the MAI and potential next steps for study of implications for developing countries, through a comparison with other investment frameworks drawn up for developing countries.*

Background: 1 - The Department for International Development

The Department for International Development (DFID) has the aim of contributing to the elimination of poverty in poorer countries, not just through its bilateral and multilateral development programmes, but through working collaboratively with other government departments to promote consistency and coherence in policies affecting LDCs' sustainable development prospects. Establishing the conditions that allow economic growth to accelerate in the poorer countries is recognised as a critical pre-requisite for sustainable poverty elimination.

The private sector provides the main impetus for this economic growth. In some countries, foreign investors have played an important role. Foreign direct investment (FDI) can bring a range of benefits to developing countries, including employment, exports, new skills and technologies. Portfolio flows can provide resources for local companies and deepen domestic capital markets. However, whilst private capital flows have increased substantially, they are heavily concentrated in a small number of the most advanced developing countries. The least developed attract little foreign investment.

DFID believes it is in the interests of developing and developed countries alike to create conditions which will help attract beneficial private investment to developing countries. This requires the right domestic policies and conditions in these countries, including political stability, transparent and accountable government and the prevention of corruption. These are crucial in order to attract and retain both foreign and domestic investment. We will encourage and assist developing countries to put in place such policies.

Background: 2 - The Multilateral Agreement on Investment

The MAI is currently being negotiated in the OECD as a high-quality agreement, providing for liberalisation of investment regimes and investor protection backed by effective dispute settlement. Negotiations are to be completed in April 1998. The Act will provide a formal basis for the preparatory work before the MAI enters into force, perhaps between one and two years later.

The fundamental principles of the MAI are that foreign investors should be accorded the better of 'national treatment' (NT) or 'most favoured nation' (MFN) treatment when investing in the jurisdiction of a signatory to the MAI. The MAI bans *de facto* as well as *de jure* discrimination. The MAI goes beyond many existing bilateral investment treaties by covering the pre-establishment phase as well as post-establishment. There will be binding state-state and investor-state dispute settlement procedures. The

Agreement also prohibits the use of certain performance requirements on foreign investors, such as local content restrictions.

The MAI is designed as a free-standing agreement, open to accession by non-OECD countries that are 'willing and able' to sign up to its provisions. There are currently five non-OECD observers from the more advanced developing countries. A Preparatory Group, established by the Final Act with all signatories as members, will, as one of its main tasks, handle membership applications by non-OECD countries until the MAI comes into force. Thereafter a Parties Group will be established, *inter alia* to deal with future membership applications. It is likely that accession will involve a WTO- or OECD-type examination as part of the negotiation process. It is possible that there might be some form of transition period for new applicants, by which they could be invited to accede at an overall level of liberalisation below the required standard, subject to an obligation to reach that standard within an agreed time-frame.

HMG's Present Policy Stance on the MAI

The Government is working to ensure that the MAI fully reflects its commitment to core labour standards and that it prevents countries from lowering environmental standards to attract investment. The Government will continue to participate actively in dialogue with developing countries about the MAI. In particular it will encourage those - mainly the more advanced - who have a particular interest in considering becoming parties to the Agreement. But it is recognised that the MAI as currently conceived may not be designed for the economic and institutional constraints of poorer developing countries. We are exploring how their needs can be taken into account.

In parallel, we are playing a full part in WTO discussions, supported by analytical work in UNCTAD, exploring the links between trade and investment and the implications for development and economic growth. We will work towards the eventual establishment of a WTO agreement on investment. We will work to ensure that the OECD Guidelines on Multinational Enterprises are closely associated with the MAI and are reviewed regularly to ensure they are up-to-date and effectively disseminated.

The Developmental Issues

It is not presently clear where LDC's best interests lie in relation to the MAI. In particular, it is not clear whether restrictive or liberal accession would best favour developmental interests, nor even whether LDCs should aspire to join the MAI at all. It is also possible that different LDCs would be advised to pursue different approaches. The pros and cons of the three main options appear to be as follows. But it is recognised that there may be other arguments and indeed other options: if any such are identified, they should be analysed and evaluated.

Restrictive Accession: The argument in favour of restrictive accession is that MAI should remain a high-level agreement with a minimum of derogations or exemptions by signatories. MAI members will naturally be reluctant to accept standards of liberalisation which are significantly worse than the lowest member country standard. The result would be a multilateral, comprehensive and legally binding investment instrument that would represent a major step towards a global 'level playing field' for investors, creating the framework which business needs to be able to take international investment decisions with greater confidence. But this may mean that only the more advanced developing countries could accede, since those with less effective institutions and domestic policy frameworks might fail on the 'able' criterion.

Liberal Accession: An alternative would be looser accession criteria - e.g. allowing derogations and exemptions for all (or some) of a signatory's legislation which is inconsistent with the requirements of the MAI. The argument in favour of this approach is that it would not exacerbate the marginalisation of developing countries from global investment flows but rather is seeking to integrate them. But developing countries may not actually be marginalised by global capital flows, in which case liberal accession becomes less attractive. In particular, the MAI may not address the fundamental constraints on FDI to some LDCs (see the recent IFC paper 'Lessons of Experience'). Secondly, if extensive exemptions and reservations are given, bad regulations may be frozen and harder to revise. Thirdly, if reservations are to be rolled back over time, the pace of change may be inappropriate for developing countries, considering the prevalence of OECD country interests in the MAI.

Non-Accession: It can also be argued, as some developing countries do, that the whole process is wrong in that if LDCs are to accede to the MAI, on whatever terms, they would be doing so to a treaty which they have had no opportunity to influence. Liberal accession would therefore make it more likely that the MAI becomes the global standard on attraction and protection of foreign investment. Moreover, as currently designed, the MAI does not offer TC to LDCs seeking accession, which could be particularly important in the light of the 1997 World Investment Report's findings on the need for competition policy to regulate FDI.

Scope of Work

Detailed analysis and policy advice is required on the merits or otherwise of these arguments, which as noted may not be exhaustive. This desk study should address existing evidence on the effect of investment treaties on beneficial FDI as a literature review and compare the provisions of the MAI with other frameworks for FDI drawn up with the needs of developing countries in mind. The study should, if necessary, distinguish between the issues facing more and less advanced developing countries, with a focus on the needs of the poorest countries. The study should draw on relevant existing work conducted by DFID or other UK Government Departments. For the purpose of this study, 'the MAI' refers to the most recent draft consolidated text and should, where necessary, consider the implications of different alternatives proposed by the Negotiating Group.

The study should cover:

- Existing literature on the sensitivity of investors, and the quality of investments, to investment treaties.
- The terms of existing bilateral investment treaties: are these broadly comparable or are there significant differences? How far do these differ from the MAI for developing countries?
- The terms of existing models for investment laws of developing countries: World Bank (1992) 'Guidelines for Legal Framework for the Treatment of Foreign Investment'; Commonwealth Code of Good Practice for national policies that attract and sustain private capital flows (forthcoming); TRIMS Agreement. How far do these differ from the MAI?
- What are the lessons from experience of dispute settlement at the International Center for the Settlement of Investment Disputes (ICSID)?
- How do MAI accession terms compare to other international treaties e.g. WTO, GATS etc?

It should be noted that a number of criteria for determining the 'development-friendliness' of international investment agreements were recently discussed at the UNCTAD Commission on Investment, Technology and Related Financial Issues. Whilst the criteria are neither definitive, exhaustive nor agreed, they should inform the assessment of the relative attractiveness of the provisions of alternative investment enabling frameworks. Current work in the WTO's Trade and Investment Working Group should also be taken into consideration.

<u>Outputs</u>

a) Recommended strategies towards the MAI for LDCs at different levels of development in the current environment.
b) An assessment of the priority that should be given to liberalisation/codification of investment rules, as envisaged in the MAI, compared to other aspects of the development process.
c) An assessment of whether the MAI provides a useful benchmark for comparison with the existing investment rules of LDCs.
d) Recommendations to DFID, attached as a confidential annex to the main report on possible developmental implications of the MAI accession scenarios set out above and proposed action for DFID in the light of the study.
e) Recommendations and Terms of Reference to DFID for areas of further study.

<u>Activities</u>

To include:

a) Literature review of sensitivity of FDI to investment treaties.
b) A comparison of the MAI with alternative investment frameworks for developing countries (World Bank and Commonwealth guidelines, TRIMS and BITs), detailing key similarities and differences.
c) An assessment of any aspects of the MAI that, if adopted, could have a positive or negative impact on the attraction of beneficial FDI by developing countries.
d) An assessment of the application of dispute settlement under ICSID, UNCITRAL and the ICC Court, and possible implications for MAI mechanisms.
e) An assessment of precedents on the terms of accession for developing countries to other international agreements, including derogations and technical assistance for developing countries.

<u>Inputs</u>

This study demands analysis of the legal framework of the MAI and its implications for investment in developing countries. Bids from a team of consultants including expertise on law, investment and development would therefore be particularly welcome. It is essential that the consultant is able to present the key findings to a non-specialist, non-academic audience.

The total inputs required are as follows:

25 x consultant days
15 x research assistant days

<u>Deliverables</u>

20 copies of bound report and 2 copies on computer disk. The report should include an Executive Summary.

A presentation to DFID by the consultant of the key findings of the report.

Timing

All bids must be received by DFID by noon on Tuesday 3 February.

The consultant will be expected to begin the study by 23 February for delivery to DFID by 23 March.