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INVESTMENT FOR ASIAN DEVELOPMENT:
Lessons so far, Challenges for the Future

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The OECD Initiative on Investment for Development

A Policy Framework for Investment: Investment Policy

For consideration in Session 4

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THE OECD INITIATIVE ON INVESTMENT FOR DEVELOPMENT[1]

A POLICY FRAMEWORK FOR INVESTMENT: INVESTMENT POLICY

1. Introduction

1. This paper addresses one of the policy areas covered in the *Policy Framework for Investment* within the context of the OECD *Initiative on Investment for Development* – investment policy.[2] The purpose of this paper is to examine how investment policy contributes to an environment that is attractive to domestic and foreign investors and that enhances the benefits of investment to societies. It constitutes an initial input and serves as background documentation for an eventual chapter of the *Policy Framework for Investment*.

2. Section 2 examines aspects of investment policy that support an attractive investment environment, with particular focus on the issues of transparency and protection. Section 3 focuses on international investment issues, with a particular focus on the issue of non-discrimination and the role of international investment agreements in this regard. Section 4 formulates questions for policy makers that could guide them in their efforts to promote investment in support of development.

3. One of the concerns sometimes associated with investment policy in the context of international agreements dealing with investment has been over the implications of such agreements for the sovereign right to regulate. This paper takes as a starting point the right to regulate in the public interest. Indeed, the principles of transparency, protection, and non-discrimination that are the focus of this paper are important features of a healthy business environment not because they place limitations on the right to regulate but rather because they underpin government efforts to regulate well.

2. The relationship between investment policy and an attractive environment for investment

4. Apart from policy issues associated specifically with international investment (addressed in the next section), the quality of a country's investment policy is primarily a function of the extent to which it a) is transparent and b) protects investment. These two fundamental qualities are emphasised, for example, in the Monterrey Consensus, which calls upon countries to strive for "a transparent, stable and predictable investment climate, with proper contract enforcement and respect for property rights, embedded in sound macroeconomic policies and institutions that allow businesses, both domestic and international, to operate efficiently and profitably and with maximum development impact. Special efforts are required in such priority areas as economic policy and regulatory frameworks for promoting and protecting investments…" (paragraph 21). The issues of transparency and protection are dealt with in turn.

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1. For background information on the OECD *Initiative on Investment for Development* and the *Policy Framework for Investment*, see Annex.

2. Other proposed policy areas to be covered in the *Framework* include, *inter alia* competition policy; investment promotion and facilitation; trade policy; tax policy; corporate governance; corporate responsibility and market integrity; human resource development; infrastructure development; and public governance. In addition to host country policy action, the contribution of international co-operation and developed countries will also be addressed

Transparency in investment policy

What steps have been taken to ensure that laws and regulations dealing with investment, as well as the processes associated with their implementation and enforcement and for handling investors' comments, are clear and transparent?

5. For domestic and foreign investors alike, knowledge about rules and regulations – including how these are implemented and how they may be changed – is often a critical determinant in the investment decision. Transparency and predictability may be even more critical for foreign investors having to cope with host country regulatory systems, cultures and administrative frameworks that are very different from their own. Indeed, the importance of transparency and predictability has motivated a number of initiatives aimed at helping governments achieve greater transparency, such as the OECD Framework for Investment Policy Transparency (Box 1). Furthermore, transparency provisions have been enshrined in virtually all modern international agreements dealing with investment, including the various agreements of the WTO, regional agreements such as the NAFTA and most recent BITs.

Box 1. The OECD Framework for Investment Policy Transparency

The OECD Framework for Investment Policy Transparency was developed by the OECD Investment Committee to assist both OECD and non-OECD governments to enhance transparency of their investment policy frameworks and to serve as a basis for experience sharing among public officials. While the focus is on the information gaps and special needs of foreign investors, they apply, in most instances, to domestic investors as well. The Framework poses fifteen questions that are supportive of a level playing field for all investors.

1. Are the economic benefits of transparency for international investment adequately recognised by public authorities? How is this being achieved?

2. What information pertaining to investment measures is made "readily available", or "available" upon request to foreign investors?

3. What are the legal requirements for making this information "public"? Do these requirements apply to primary and secondary legislation? Do they apply to both the national and sub-national levels? Is this information also made available to foreign investors in their countries of origin?

4. Are exceptions/qualifications to making information available clearly defined and delimited?

5. What are the main vehicles of information on investment measures of interest to foreign investors? What may determine the choice of publication avenues? What efforts are made to simplify the dissemination of this information?

6. Is this information centralised? Is it couched in layman's terms? In English or another language? What is the role of Internet in disseminating essential/relevant information to foreign investors?

7. Have special enquiry points been created? Can investment promotion agencies fulfil this role?

8. How much transparency is achieved via international agreements or by international organisations?

9. Are foreign investors normally notified and consulted in advance of the purpose and nature of regulatory changes of interest to them? What are the main avenues? Are these avenues available to all stakeholders?

10. Are the notice and comment procedures codified? Do they provide for timely opportunities for comment by foreign investors and accountability on how their comments are to be handled?

11. Are exceptions to openness and accessibility to procedures clearly defined and delimited?

12. What are the available means for informing and assisting foreign investors in obtaining the necessary licensing, permits, registration or other formalities? What recourse is made to "silent and consent" clauses or "a posteriori" verification procedures?

13. What are foreign investors' legal rights in regard to administrative decisions?

14. To what extent "one-stop" shops may assist foreign investors fulfil administrative requirements?

15. What efforts are being made to address capacity building bottle-necks?

6. The growing consensus about the importance of transparency does not imply that transparency-enhancing reforms are easy to enact and implement. All countries -- developed and less developed – face significant obstacles to reform. OECD work finds that the difficulties stem from three areas:

- *Politics*. The main obstacles to transparency-enhancing reform are political. Attempting to overcome the natural political dynamic in favour of "concentrated benefits" is an ongoing struggle for all political systems. Lack of transparency also shields government officials from accountability. Thus, many actors – both inside and outside the public sector – can have a stake in non-transparent practices. It is for this reason that, despite the broad apparent agreement in principle about their benefits, actual implementation of transparency-enhancing reforms are likely to involve painful shifts in the way policies are made and implemented, especially in countries with highly opaque policy environments. The difficulty will be to develop the political momentum for pro-transparency reform and to prevent backsliding.

- *Institutions*. All countries' institutional structures make certain transparency measures possible and make others more difficult. International agreements tend to focus on core transparency measures. These are the starting points for other communication processes that are closely linked to national institutions that usually evolve slowly and incrementally. The challenge is to create the conditions that help countries move forward on core measures, while also working with and enhancing the distinctive national characteristics of transparency practices.

- *Technological, financial and human resources*. Transparency requires access to resources and entails administrative costs. It involves the creation of registers, web-sites, the development of "plain language" texts and other mechanisms for making the language of legal and regulatory codes accessible to target audiences. For foreigners, translation of the host country's texts into relevant foreign languages would also require resources and entail costs. However, most studies suggest that the costs of opacity far outweigh the costs of transparency-enhancing reforms.

7. There are many options for promoting transparency-oriented reform. Some important elements for implementing regulatory transparency include:

- *Consultation with interested parties*. The widespread use of consultations reflects a growing recognition that effective rules cannot rely solely on command and control -- the individuals and organisations, including from civil society, who have a stake in the rules need to be recruited as partners in their implementation. Consultation is the first phase of this recruitment process. It can also generate information and ideas that would not otherwise be available to public officials. Consultation mechanisms are becoming more standardised and systematic. This enhances effective access by improving predictability and outside awareness of consultation opportunities. There is a trend toward adapting forms of consultation to the stage in the regulatory process. Consultation tends to start earlier in the policy making process, is conducted in several stages and employs different mechanisms at different times. Problems have been noted as well. For example, consultation fatigue – where some organisations are overwhelmed by the volume of material on which their views are requested – has been noted in several countries.

- *Legislative simplification and codification*. There is increased use of legislative codification and restatement of laws and regulations to enhance clarity and identify and eliminate inconsistency.

- *Plain language drafting*. OECD work has documented that twenty-three Member countries require the use of "plain language drafting" of laws and regulation. Sixteen Member countries issue guidance materials and/or offer training programmes to help with clearer drafting.

- *Registers of existing and proposed regulation*. The adoption of centralised registers of laws and regulations enhances accessibility. OECD work documents that eighteen Member countries stated in end-2000 that they published a consolidated register of all subordinate regulations currently in force and nine of these provided that enforceability depended on inclusion in the register. Many countries now also commit to publication of future regulatory plans.

- *Electronic dissemination of regulatory material*. Three quarters of OECD countries now make most or all primary legislation available via the Internet.

- *Review of administrative decisions.* Transparency in the implementation or enforcement of rules and regulations is as important as the transparency of the rules and regulations themselves. Clear criteria and transparent procedures for administrative decisions and their possible review can serve to bolster confidence in the regulatory framework for investment.

8. Highlighting the universal nature of the challenges countries face with respect to transparency, a synthesis report on progress with respect to regulatory reform in the OECD found that performance is still far from satisfactory (OECD 2002a, page 41). All twelve countries surveyed had problems with legal texts that were difficult to understand and with overly complex regulatory structures. Biased participation in public consultation was noted for 8 countries and a tendency to exclude less powerful groups from consultation was cited for 4 countries. Other problems included lack of systematic policy analysis (often called regulatory impact analysis, or RIA) as a tool for improving the quality of consultations and a lack of clear standards in licensing and concessions (7 countries). Despite these challenges, the growing recognition of the importance of transparency for the investment climate has been reflected in considerable progress and efforts across virtually all countries, including through innovative new approaches to regulation specifically for investors.

9. Common transparency-related problems and possible solutions are outlined in Box 2. These provide policy-makers with more detailed, operational criteria for consideration in answering the overarching question posed at the beginning of this section.

Box 2. Transparency and predictability in investment policy: from principles to action

What steps have been taken to ensure that laws and regulations dealing with investment, as well as the processes associated with their implementation and enforcement, are clear and transparent?

Policy issue: Some form of public consultation is used when developing new regulations, but not systematically and with no minimum standards of access. Participation biased or unclear.
Possible action: Adopt minimum standards, with clear rules of the game, procedures, and participation criteria, applicable to all organs with regulatory powers. Use "notice and comment" as a safeguard against regulatory capture. Reduce use of "informal" consultations with selected partners.

Policy issue: Regulatory reform programme and strategy are not transparent to affected groups
Possible action: Develop coherent and transparent reform plans, and consult with major affected interests in their development

Policy issue: Information on existing regulations not easily accessible (particularly for SMEs and foreign traders and investors)
Possible action: Creation of centralised registries of rules and formalities with positive security, use one-stop shops, use information technologies to provide faster and cheaper access to regulations.

Policy issue: Legal text difficult to understand
Possible action: Adopt principle of plain language drafting

Policy issue: Complexity in the structure of regulatory regimes
Possible action: Codification and rationalisation of laws

Policy issue: RIA is never or not always used in public consultation
Possible action: Integrate RIA at an early stage of public consultation

Policy issue: Inadequate use of communications technologies
Possible action: Use Internet more frequently in making drafts and final rules available as a consultation mechanism

Policy issue: Lack of transparency in government procurement
Possible action: Adopt explicit standards and procedures for decision-making

Policy issue: Lack of transparency in ministerial mandates and roles of regulators
Possible action: Clarify responsibilities between regulators

Policy issue: Too much administrative discretion in applying regulations
Possible action: Strengthen administrative procedures and accountability mechanisms. Publish criteria for administrative decisions and require decisions to be motivated against these criteria.

Policy issue: Inadequate use of international standards
Possible action: Encourage the use of international standards government-wide, and track the use of uniquely national standards. Issue guidance for translation of international standards into national practice.

Policy issue: Lack of clear standards in licensing and concessions decisions, such as in telecommunications
Possible action: Reduce the use of concessions and licences to the extent possible by moving to generalised regulation, announce clear criteria for decisions on concessions and licenses, use public consultation for changes in existing licenses and concessions

Policy issue: Decisions of independent regulators not transparent enough
Possible action: Apply RIA to independent regulators, ensure that independent regulators also use public consultation processes with regulated and user groups

Protection of property and contractual rights

10. As mentioned in the introduction to this section, the protection of investment (including physical and intellectual property rights) is widely accepted as a necessary condition for the development of a healthy investment environment, as reflected, for example, in the emphasis placed on this issue in the Monterrey Consensus and other important development initiatives. Indeed, investment protection, which is a sub-category of the more general protection of property, is closely associated with fundamental human rights. Article 17 of the United Nations Universal Declaration of Human Rights states that "(1) Everyone has the right to own property alone as well as in association with others" and "(2) No one shall be arbitrarily deprived of his property." Article 27(2) of the Declaration would also seem to hold relevance from an investment perspective: "Everyone has the right to the protection of the moral and material interests resulting from any scientific, literary or artistic production of which he is the author."

11. The protection of such rights, including with respect to private investment, have also been closely linked to economic development. Research by the World Bank in Poland, Russia, Slovakia and Ukraine shows that entrepreneurs who believe their property rights are secure reinvest between 14 and 40 per cent more of their profits than those who do not enjoy secure property rights. Likewise, farmers in Ghana and Nicaragua invest up to 8 per cent more in their land when their rights to it are secure. Indeed, the development literature strongly supports a positive relationship between property rights and growth.[3] With respect to the protection of investment, two broad policy areas stand out.[4] These are; 1) the promotion and protection of property rights, and 2) contract enforcement, including timely and adequate compensation for expropriations.

The promotion and protection of property rights

Has the Government established an effective titling program for land and other forms of property, and what is the national scope of its coverage?

12. Secure rights to land and other forms of property are an important pre-requisite for a healthy investment environment. They reduce the risk of fraud in transactions, encourage various types of investment to enhance the value and productivity of the property in question (as well as investment associated with environmental stewardship), and, perhaps most importantly, can underpin a healthy credit system.

13. According to the World Bank, the value of rural land in Brazil, Indonesia, the Philippines, and Thailand increased by anywhere from 43 per cent to 81 per cent after being titled. For urban land, titling increased the value by 14 per cent in Manila, by almost 25 per cent in both Guayaquil, Ecuador, and Lima, Peru, and by 58 per cent in Davao, Philippines. Titling land has also been shown to increase productivity. The output by farmers in Thailand who enjoyed clear ownership was 14-25 per cent higher than those working untitled land (World Bank, 2004, p. 80).

14. Titling can also improve access to credit since registered title allows lenders to verify ownership for the purposes of collateral. For example, in Thailand, farmers with title borrowed anywhere from 50 per cent to five times more from banks and other institutional lenders than farmers with identical land in quality but without title. For people living in urban areas, the access to credit afforded by title provides important support for entrepreneurs and micro-enterprises. In this regard, the titling of automobiles, equipment, machinery and other valuable forms of "movable" property can help to bolster credit and

3. See World Bank (2004). World Development Report 2005: A Better Investment Climate for Everyone (World Bank: Washington, D.C.), p. 79.

4. As originally identified in World Bank (2004). World Development Report 2005: A Better Investment Climate for Everyone (World Bank: Washington, D.C.), p. 80.

investment in the same way as the titling of land. In 2000, Indonesia established a title registry for movable assets. In 2003, 12,000 interests in vehicles, machinery and other forms of property covered by the new law were registered (World Bank, 2004, p. 84).

15. On a larger scale, the example of the Compania Peruana de Teléfonos provides an indication of the potential economic impact of proper title. In 1990, the company was valued on the Lima stock exchange at $53 million. The company could not be sold or privatised however due to a lack of clarity with respect to the company's title over many of its assets. After a concerted effort to reform the title system and to establish clear title over CPT's assets lasting 3 years, CPT was sold for $2 billion, 37 times its previous market valuation.[5]

16. The main conclusion from the above is that governments should maintain land and property registries with a view to encouraging investment and increasing efficiency across all segments of the economy, from rural farmers to large-scale manufacturing. In countries that do not have well developed land registries, the challenges can be significant and long-term political commitment is required (see, for example, Box 3 on Thailand's 20-year program to title rural land). Nevertheless, the experiences of many countries attest to the importance of promoting and protecting ownership rights to land and other property.

Box 3. Thailand's 20-year program to title rural land

In 1982, the Thai government began a 20-year project to title and register farmland throughout the kingdom. The aim was to enhance farmers' access to institutional credit and increase their productivity by giving them an incentive to make long-term investments.

Just over 8.5 million titles were issued during the life of the project. Along with those issued outside the project, the number of registered titles increased from 4.5 million in 1984 to just over 18 million by September 2001. Studies conducted during the project show that it met both its objectives: titled farmers secured larger loans on better terms than untitled farmers, and productivity on titled parcels rose appreciably.

The success in Thailand is attributed to several factors;

1) there was a clear vision for the project, a long-term plan to achieve it, and a commitment by the government and key stakeholders to project implemention;

2) A strong policy, legal, and institutional framework was in place for land administration;

3) The project built on earlier efforts to issue documents recognizing holders' rights to their land;

4) registration procedures developed by the Department of Lands were efficient and responsive to public demand;

5) The public had confidence in the land administration system and actively participated in the reform process;

6) The interests that can complicate projects in other countries – public notaries, private lawyers, and private surveyors – were not present.

Source: World Bank (2004), p. 83, Burns (2004).

The promotion and protection of intellectual property rights

Have laws and regulations for the protection of intellectual property rights and effective enforcement mechanisms been adopted? Is the level of protection adequate to encourage innovation and investment by domestic and foreign firms? What steps have been taken to develop strategies, policies and programs to meet the intellectual property needs of SMEs?

5. See De Soto, "The Secret of Non-Success" in OECD (2002), p. 49.

17. One particular form of property that has presented particular challenges for policy makers concerns intellectual property rights. Inventors and authors often require an incentive to develop innovative products, as has been recognized since at least the 4th century. Today the incentive is provided by granting creators of new inventions, software programs, or other products a patent, copyright, or other similar right to their creation. An idea of how powerful this stimulus can be comes from a recent analysis of spending on research and development by American firms.

18. A modest increase in the value managers expect to realize from patenting new products was found to boost R&D by anywhere from 11 percent in the biotech industry to 8 percent in the pharmaceutical industry to 7 percent in the chemical industry**.** This stimulus comes at a price. Intellectual property rights give their holders the exclusive rights to products and processes. During this period, holders are free to determine prices and output as would a monopoly. Intellectual property rights thus need to strike a balance between society's interests in fostering innovation and in keeping prices to consumers low and, especially in the case of essential medicines, in sufficient supply. (On the evolving debate over intellectual property rights, see Box 4).[6]

Box 4. The benefits of intellectual property rights in developing countries: the shifting debate

Traditionally, a limited number of developed countries in which a high proportion of the world's R&D was concentrated were the main "demandeurs" of strong intellectual property rights internationally. Four recent developments are helping to broaden acceptance of the benefits of intellectual property rights.

First, more firms in more developing countries are now producing innovative products and thus have a direct stake in the protection of intellectual property rights. In Brazil and the Philippines short-duration patents have helped domestic firms adapt foreign technology to local conditions, while in Ghana, Kuwait, and Morocco local software firms are expanding into the international market. India's vibrant music and film industry is in part the result of copyright protection, while in Sri Lanka laws protecting designs from pirates have allowed manufacturers of quality ceramics to increase exports.

Second, a growing number of developing countries are seeking to attract FDI, including in industries where proprietary technologies are important. But foreign firms are reluctant to transfer their most advanced technology, or to invest in production facilities, until they are confident their rights will be protected.

Third, there is growing recognition that consumers in even the poorest countries can suffer from the sale of counterfeit goods, as examples ranging from falsely branded pesticides in Kenya to the sale of poisoned meat in China attest. Consumers usually suffer the most when laws protecting trademarks and brand names are not vigorously enforced.

Fourth, there is a trend toward addressing intellectual property issues one by one, helping to identify areas of agreement and find common ground on points of difference. Although the issue is not yet resolved, an agreement at the WTO ministerial meeting in November 2001 reflects developing countries' need for access to medicine. Discussion is also under way on policies that would give manufacturers of patented goods greater flexibility to sell at lower prices in poor countries than in wealthier ones.

Source: World Bank (2004), chapter 4.

19. Furthermore, different areas of intellectual property present their own distinct challenges. For example, with the rise of modern biotechnology, genetic resources have taken on increasing economic, scientific and commercial value for a wide range of stakeholders. At the same time, tradition-based creations, like folklore and the many forms in which it is expressed, have acquired a new economic and cultural potential, thanks to the multitude of commercial and dissemination options made available by the Internet and the global information society. Issues such as these have often called for international solutions. For example, WIPO has been working closely with its member States to clarify the intellectual property dimensions of these subjects. In order to identify and address the relevant intellectual property issues, WIPO member States established, in September 2000, a WIPO Intergovernmental Committee on

6. The link between intellectual property protection and competition is also addressed in the competition policy chapter of the Policy Framework for Investment [see DAFFE/IME/TF(2004)3/REV1].

Intellectual Property and Genetic Resources, Traditional Knowledge and Folklore (IGC). Questions addressed in the IGC include, e.g. access to genetic resources and benefit-sharing, protection of traditional knowledge, whether or not associated with those resources, and protection of expressions of folklore.

20. Another important issue associated with intellectual property rights concerns SMEs. A common assumption in the policy debate over intellectual property rights is that these only concern large firms and multinational enterprises (MNEs) with significant research and development programmes. However, small and medium-sized enterprises (SMEs) are a driving force behind innovation and the new economy. Their innovative and creative capacity, however, is not always fully exploited as SMEs tend to under-utilise the intellectual property system – partly due to their lack of awareness. Governments can help by, for example;

- Promoting a greater use of intellectual property system;
- Developing strategies, policies and programs to meet the intellectual property needs of SMEs;
- Improving the capacity of relevant public, private and civil society institutions, such as business and industry associations, to provide IP-related services to SMEs;
- Providing comprehensive web-based information and basic advice on IP issues to SME support organisations.

Contract enforcement

Is an effective system of contract enforcement in place? Is this system widely accessible to all segments of society? Have alternative systems of dispute settlement been established, including mediation, to ensure the widest possible scope of protection, at the lowest possible cost?

21. Protecting and promoting property rights, including through the establishment of an efficient land registry system and a framework for the protection of intellectual property, encourages investment in part by giving owners confidence in the value of what they own (as well as confidence that they will be able to reap the rewards from any investments aimed at increasing values). This dynamic applies whether the property owner is a subsistence rural farmer or a Fortune Global 500 MNE. However, the value of property is only realised when it is involved in a transaction. This transaction could involve using the property as collateral in order to obtain a loan or it could involve the outright sale of the property in question. Indeed, it is ultimately the *possibility* of using an asset in a given market transaction that gives the asset its value. Therefore, just as it is important for the investment climate that title to assets be clear, it is equally important that investors have trust in the channels through which transactions involving these assets take place.

22. A strong link exists between the quality of the institutions through which transactions involving assets take place and the investment environment. The World Bank's Investment Climate Surveys, for example, show that in some countries the average time required to enforce a contract through the local court system can exceed four years (compared, for example, to an average of under 50 days in the Netherlands). Bureaucratic and cumbersome procedures for dealing with commercial transactions effectively serve to undermine the benefits to the investment environment of any established property rights.

23. One solution to this problem has involved combining procedural reform, reform of the management systems in courts, and the increased use of information technology. In a pilot test case in Ecuador, this approach reduced the average time to process a case by 85 per cent (World Bank, 2004, p. 86). Another option that has yielded positive results in some cases is the establishment of separate courts

specialising in only commercial transactions. However, such specialised courts require strong political support in order not to be 'captured' by special interest groups or powerful vested interests. In Tanzania, this approach has worked well, in part because the new courts deal with banks and other financial institutions that provide strong support. Furthermore, this initiative was accompanied by concerted and successful efforts to gain the support of key members within the legal establishment (World Bank, 2004, p. 88).

24. Another source of friction with respect to contract enforcement concerns impediments to alternative forms of dispute settlement. This is particularly important in countries in which the court system is characterised by the types of problems outlined above. In many countries, arbitration, mediation, and conciliation have played an important role in improving efficiency, providing parties to disputes a choice of the most appropriate avenue, lessening the burden on courts, allowing a broader cross-section of property holders access to some form of dispute settlement, and lowering costs. Both Colombia and Peru have established successful arbitration chambers through the Bogotá and Lima Chambers of Commerce, respectively. Courts continue to play an important role however, especially with respect to the enforcement of awards handed down by less formal dispute settlement bodies that lack the full legal authority of the judicial system. Conversely, it is also important that limits be placed on the possibility of 'forum shopping', whereby every time someone loses a case in arbitration they simply take the complaint to the formal court system to try again, thus negating the benefits that less formal dispute settlement channels can bring.

25. Irrespective of the actual channels through which disputes are handled and judgements enforced, it remains that an effective system that deals with these issues in a timely manner goes hand in hand with clear property rights themselves in support of a healthy investment environment.

Timely and adequate compensation for expropriation

Does the government maintain a policy of timely and adequate compensation for expropriation? Have explicit and well-defined limits on the ability to expropriate been established, such as guidelines on what constitutes public interest? What channels exist for reviewing the exercise of this power or for contesting it?

26. A natural corollary of the protection of property rights is the need for compensation when a government expropriates private property in the broader public interest. This need is uncontested and, indeed, is reflected in many international agreements dealing with investment. The 1992 World Bank Guidelines section IV (1) on "Expropriation and Unilateral Alterations or Termination of Contracts", state that: "A state may not expropriate or otherwise take in whole or in part a foreign private investment in its territory, or take *measures which have similar effects*, except where this is done in accordance with applicable legal procedures, in pursuance in good faith of a public purpose, without discrimination on the basis of nationality and against the payment of appropriate compensation".

27. Notwithstanding the widespread acceptance of the need for timely and adequate compensation, the power of government to expropriate can raise difficult policy issues that usually involve a careful balancing of interests and judgement on the part of policy makers. Once a government has indicated its intention to expropriate land or other property, the market value of the property in question will normally depreciate. For example, the owner of land that will be permanently flooded due to the construction of a dam will have a hard time using this land as collateral to obtain a loan from a bank, let alone selling it. The question in this case is how to determine a fair or adequate price for the land.

28. While the problem outlined above is somewhat intractable (in the sense that there is no simple solution for determining the "fair" price), governments can at least take action to ensure that the process is

driven by transparent rules that define the situations in which expropriations are allowed and the means by which compensation is to be determined as clearly as possible.

29. An important grey area that has emerged in recent years concerns "indirect expropriations" or "takings" (Box 6). These are instances where the policies of a government are perceived to seriously erode the value of the investment in question. Irrespective of the merits of any given case, from a policy perspective, governments need to be mindful of the potential negative signalling effects associated with indirect expropriation. While determination of a direct expropriation is relatively straightforward, determining whether a measure falls into the category of indirect expropriation has required tribunals to undertake thorough case-by-case examinations. In general, however, non-discriminatory regulatory actions that are designed and applied to protect legitimate public welfare objectives, such as public health, safety and the environment, are not considered to constitute indirect expropriations.

Box 6. The evolution of the expropriation issue in international law

It is a well recognised rule in international law that the property of aliens cannot be taken, whether for public purposes or not, without adequate compensation. Two decades ago, the disputes before the courts and the discussions in academic literature focused mainly on the standard of compensation and measuring of expropriated value. The divergent views[1] of the developed and developing countries raised issues regarding the formation and evolution of customary law. Today, the more positive attitude of countries around the world toward foreign investment and the proliferation of bilateral treaties and other investment agreements requiring prompt, adequate and effective compensation for expropriation of foreign investments have largely deprived that debate of practical significance for foreign investors.

Disputes on direct expropriation – mainly related to nationalisation that marked the 70s and 80s -- have been replaced by disputes related to foreign investment regulation and "indirect expropriation". Largely prompted by the first cases brought under NAFTA, there is increasing concern that concepts such as indirect expropriation may be applicable to regulatory measures aimed at protecting the environment, health and other welfare interests of society. The question that arises is to what extent a government may affect the value of property by regulation, either general in nature or by specific actions in the context of general regulations, for a legitimate public purpose without effecting a "taking" and having to compensate for this act.

Source: OECD (2004)

3. The international dimension of investment policy

Non-discrimination

30. Non-discrimination, as a general principle, is generally perceived as being a laudable feature of public policy. In social policy, most governments have laws, often enshrined in national constitutions, against discrimination based on gender, religion, or race. In economic policy, most governments generally do not discriminate based on nationality and, indeed, the core principles that underpin the multilateral trading system concern non-discrimination. However, it remains that, with respect to investment, States' exercise of the right to regulate sometimes involves discriminating against foreign investors.[7] While the right to regulate is not in question, policy makers need to consider, beyond commitments to non-discrimination undertaken in international agreements, instances where discrimination in investment policy is either inadvertent or, when it is intended, whether it is the best option for meeting particular policy objectives. A core principle that underpins non-discrimination in investment policy is national treatment.

7. Conversely, reverse or positive discrimination measures, whereby foreign investors are treated more favourably than domestic investors, are also frequent when countries compete aggressively by means of preferential financial and other incentives to attract FDI. The issue of incentives is addressed in a separate chapter of the PFI, on investment promotion and facilitation [DAF/INV/TF(2005)9].

National treatment

While recognising the rights of governments to regulate, and aside from specific commitments in international investment agreements, does the government uphold the principle of national treatment as a guiding principle? How are exceptions to national treatment evaluated with respect to their costs and benefits and are these exceptions transparent and time bound?

31. "National Treatment" is the commitment by a country to treat enterprises controlled by the nationals or residents of another country, no less favorably than domestic enterprises in like situations. The OECD Code of Liberalisation of Capital Movements, for instance, provides that non-resident investors should be allowed to establish a subsidiary or branch or take participation in an existing domestic enterprise on conditions equivalent to those offered to resident investors. The OECD National Treatment Instrument applies a similar principle for operations by foreign controlled enterprises once established in the country. Beyond this straightforward definition, however, the national treatment principle has been applied in very different ways by different countries and in different contexts. One of the reasons for this is that, while most countries generally acknowledge the benefits of openness and non-discrimination, all countries maintain exceptions to the national treatment principle and, depending upon the country in question, these exceptions vary. Exceptions to national treatment include across-the-board special screening procedures for FDI entry, more burdensome licensing requirements for foreign investors than for domestic investors, sectoral foreign equity ownership ceilings, denial of access for foreign controlled-established enterprises to local finance and incentives, etc. Common examples of sectors where many countries maintain exceptions to national treatment concern investment in financial services, land, and international transport.

32. The divergent approaches to national treatment across countries reflect governments' "right to regulate". Subject to specific commitments made in international agreements (see Box 7), governments decide which industries will be subject to national treatment and those that will not. Usually this choice is motivated by some combination of development, equity, and national interest considerations, all of which can be completely valid. However, as argued in the background document on competition policy for the PFI [DAFFE/IME/TF(2005)3/REV1], any policies that favour some firms over others (i.e. any policies that derogate from national treatment) come at a cost, namely a reduction in competition. The question is therefore not whether or not a government can discriminate between domestic and foreign producers, but rather whether the potential benefits of this discrimination are outweighed by the costs borne by consumers. Exceptions from national treatment need to be evaluated to ensure that this is not the case, as well as with a view to determining whether the original reasoning behind an exception (e.g. infant industry protection for an industry that is no longer an infant) remains valid. Such considerations are especially important in service sectors that play an intermediary role supporting a wide range of economic activities and that contribute to productivity and growth across the economy (e.g. telecommunications).

MFN

While recognising the rights of governments to regulate, and aside from specific commitments in international investment agreements, does the government uphold the principle of most-favoured nation treatment as a guiding principle? How are exceptions to MFN evaluated with respect to their costs and benefits and are these exceptions transparent and time bound? Have the costs and harm to domestic investors of exceptions to MFN been evaluated and taken into consideration?

33. Another important principle in the context of international investment concerns most-favoured nation (MFN) treatment. Like national treatment, MFN is a relative concept insofar as it entails a comparison of the treatment of firms based on nationality. To provide MFN treatment under investment agreements means that an investor or investment from one country is treated by the host country "no less favourably" with respect to a given subject matter than an investor or investment from any third country. As with the application of the national treatment principle, MFN commitments towards investment vary

considerably across countries (Box 7). As in the case of national treatment, one of the main issues with respect to MFN pertains to the impact of exceptions on competition and the possible negative impact this can have on the investment environment.

34. One issue that is rarely considered concerns the harm that MFN exceptions can cause domestic firms. This harm is transmitted through two channels. First, MFN exceptions reduce the exposure of MNEs to their competitors. However, an MNE with control over a given national product market could be more harmful to local niche players in the same industry than an MNE that has to compete with international rivals. The second channel through which exceptions to MFN can hurt local enterprises concerns the supply chain. Any MNE that is uncontested in a local market will be able to exercise 'hold up', the practice of squeezing suppliers through its monopsonistic position and squeezing buyers through its monopolistic position. In this case, exceptions to MFN can lead to a situation in which the often hoped for linkages between international business and the local economy actually become a negative factor. Exceptions from national treatment can also give rise to the same problems, the only difference being that the firm practicing 'hold up' and extracting profits at the expense of the economy as a whole is homegrown.

35. Exceptions from MFN and national treatment invariably entail costs to an economy, most notably in the form of reduced competition, and these costs need to be evaluated. This is a good example of a horizontal policy issue for which it would be desirable for competition authorities to be involved in decisions involving derogations from non-discrimination.[8]

Box 7. Non-discrimination in international agreements

With respect to foreign investment, national treatment and MFN are the cornerstones of non-discrimination in most international agreements dealing with investment. Indeed, it is only in international investment agreements that national treatment and MFN take the form of binding obligations. However, the ways in which these principles are treated in international treaties varies significantly from one agreement to another. For example, some agreements take a top-down or negative list approach, whereby the commitment to national treatment and MFN applies except in specifically identified exceptions (e.g. NAFTA). Alternatively, some agreements are characterised by a bottom-up or positive list approach whereby national treatment or MFN only apply to scheduled sectors (e.g. GATS). Distinctions are also made concerning pre- and post-establishment coverage of non-discrimination provisions. Many bilateral investment treaties have emphasised the post-establishment application of national treatment and MFN. In other words, governments have reserved their right to screen prospective foreign investments and to maintain approval procedures to determine whether these will be allowed. However, some governments have also started to include pre-establishment national treatment and MFN obligations in their international agreements (e.g. NAFTA, Canadian and United States BITs and Japan's recent agreements).

International co-operation

Has the government entered into international treaties on the promotion and protection of investment? To what extent are steps for their timely ratification in place? Are existing international treaties periodically reviewed with a view to determining whether their provisions match the general level of ambition of the government with respect to transparency, investment protection, non-discrimination and progressive liberalisation towards creating a more attractive environment for investment?

36. International agreements containing investment provisions are an increasingly common form of international co-operation. Bilateral investment treaties in particular constitute an important pillar of the international investment architecture. By 2004 more than 2332 such treaties had been concluded, the majority of them after 1990. Furthermore, most modern regional trade agreements also cover investment issues. For example, the NAFTA contains a chapter on investment as well as a separate chapter dealing with services. Bilateral and regional agreements dealing with investment issues increasingly involve

8. These issues are addressed in the competition policy chapter of the PFI.

developed and developing countries, reflecting the perceived mutual benefits of investment promotion and protection.

37. While regionalisation is often characterised as a second best solution compared with multilateral approaches to international trade and investment liberalisation, regional agreements do have a distinct advantage. Most countries that have entered into agreements containing high-standard rules on investment had either already been liberalising their investment regimes unilaterally or had experimented with investment rules in prior agreements. For example, a number of bilateral agreements recently negotiated by the North American Free Trade Agreement (NAFTA) signatories (such as Canada-Chile, Mexico-E.U., United States-Jordan) contain provisions almost identical to NAFTA's chapter 11. Where countries have only recently begun to liberalise their investment regimes and where these have traditionally been relatively restrictive, the preference has been for less encompassing agreements covering limited rights of establishment and the movement of capital. In other words, the negotiation of investment rules in regional agreements could be characterised as taking place at the investment policy margin. Countries at similar levels on the investment liberalisation 'trajectory' can scale their investment rule-making ambitions in line with historical local norms on international investment.

5. Conclusion: Issues for consideration

38. Investment policy is at the heart of the broader policy framework aimed at creating a healthy investment climate. This paper has emphasised three core principles that should guide the formulation of investment policy towards developing a better investment environment for both domestic and international investors. These are transparency (including predictability), protection, and non-discrimination.

39. While recognizing that different countries at different levels of development will have different priorities, this paper has identified certain issues and questions that policy makers need to consider with a view to encouraging investment, both domestic and foreign, and ensuring the contribution of investment to development. These include:

1. What steps have been taken to ensure that laws and regulations dealing with investment, as well as the processes associated with their implementation and enforcement and for handling investors' comments, are clear and transparent?

2. Has the Government established an effective titling program for land and other forms of property, and what is the national scope of its coverage?

3. Have laws and regulations for the protection of intellectual property rights and effective enforcement mechanisms been adopted? Is the level of protection adequate to encourage innovation and investment by domestic and foreign firms? What steps have been taken to develop strategies, policies and programs to meet the intellectual property needs of SMEs?

4. Is an effective system of contract enforcement in place? Is this system widely accessible to all segments of society? Have alternative systems of dispute settlement been established, including mediation, to ensure the widest possible scope of protection, at the lowest possible cost?

5. Does the government maintain a policy of timely and adequate compensation for expropriation? Have explicit and well-defined limits on the ability to expropriate been established, such as guidelines on what constitutes public interest? What channels exist for reviewing the exercise of this power or for contesting it?

6. While recognising the rights of governments to regulate, and aside from specific commitments in international investment agreements, does the government uphold the principle of national

treatment as a guiding principle? How are exceptions to national treatment evaluated with respect to their costs and benefits and are these exceptions transparent and time bound?

7. While recognising the rights of governments to regulate, and aside from specific commitments in international investment agreements, does the government uphold the principle of most-favoured nation treatment as a guiding principle? How are exceptions to MFN evaluated with respect to their costs and benefits and are these exceptions transparent and time bound?

8. Have the costs and harm to domestic investors of exceptions to national treatment and MFN been evaluated and taken into consideration?

9. Has the government entered into international treaties on the promotion and protection of investment? To what extent are steps for their timely ratification in place? Are existing international treaties periodically reviewed with a view to determining whether their provisions match the general level of ambition of the government with respect to transparency, investment protection, non-discrimination and progressive liberalisation towards creating a more attractive environment for investment?

BACKGROUND DOCUMENTATION[9]

OECD (2005) National Treatment for Foreign-Controlled Enterprises.

OECD (2005) Transparency and Third Party Participation in Investor-State Dispute Settlement Procedures.

OECD (2004) Fair and Equitable Treatment: Elements of its Content as Interpreted by Arbitral Tribunals.

OECD (2004) Indirect Expropriation and Governmental Measures Affecting Property of Nationals Not Requiring Compensation: How is this Distinction Formulated at the National Level?

OECD (2004) Most-Favoured-Nation Treatment in International Investment Law.

OECD (2003) OECD Codes of Liberalisation of Capital Movements and Current Invisible Operations: User's Guide.

OECD (2003) Fair and Equitable Treatment Standard in International Investment Law.

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OECD (2003) A Framework for Investment Policy Transparency.

OECD (2003) Checklist for Foreign Direct Investment Incentive Policies.

OECD (2002) Forty Years' Experience with the OECD Code of Liberalisation of Capital Movements.

OECD (2002) Foreign Direct Investment: Maximising Benefits, Minimising Costs.

World Bank (2004) World Development Report 2005: The Investment Climate, Growth, and Poverty.

9. OECD documents are available on the OECD website at: www.oecd.org/investment

ANNEX

OECD INITIATIVE ON INVESTMENT FOR DEVELOPMENT: TOWARDS A POLICY FRAMEWORK FOR INVESTMENT

The Monterrey Consensus

Investment has proven to be a powerful catalyst for innovation, sustainable growth and poverty reduction. Despite positive trends in the past decade, business investment and enterprise development in non-OECD regions continue to fall short of development needs. The Monterrey Consensus identified private capital, including foreign direct investment, as "vital complements to national and international development efforts" and emphasised the need "to create the necessary domestic and international conditions to facilitate direct investment flows".

The OECD Initiative on Investment for Development

In support of the Monterrey Consensus, the OECD launched the *Initiative on Investment for Development* in 2003 in Johannesburg, South Africa. The *Initiative* includes three closely inter-related projects. These involve: 1) the development of a *Policy Framework for Investment*, described below; 2) drawing lessons on the use of ODA in support of countries' efforts to mobilise investment for development; and 3) sharing the OECD's experience with investment policy peer reviews as capacity building mechanisms. The *Initiative on Investment for Development* is inspired by values that underpin the Monterrey Consensus: transparency, accountability and respect for human rights, including the right to development.

The OECD has a long history with peer learning, and consensual approaches towards the development of "best practice" across a wide range of policy areas that are relevant from an investment perspective. As such, the OECD is well placed as a forum for countries to share their experiences, to develop common understanding, and to elaborate policy guidance aimed at enhancing the contribution of domestic and foreign investment to development, as called for in the Monterrey Consensus.

The Policy Framework for Investment

Within the context of the OECD *Initiative on Investment for Development*, and in keeping with OECD Members' commitment to the effective implementation of the Monterrey Consensus, the OECD Investment Committee and its partners have initiated work on a *Policy Framework for Investment*. The *Framework* is intended as a non-prescriptive checklist of issues for consideration by any interested governments engaged in domestic reform, regional co-operation or international policy dialogue aimed at creating an environment that is attractive to domestic and foreign investors and that enhances the benefits of investment to society. The *Framework* could also serve as a reference point for investment promotion agencies, donors as they assist recipient country partners in improving the investment climate, and businesses, trade unions, and NGOs in their dialogue with governments. The Policy Framework for Investment recognises that the needs of countries at different levels of development call for a flexible and non-prescriptive approach that provides constructive policy guidance across a range of areas in order to maximise the contribution of investment to development.

While the Policy Framework for Investment is addressed to governments, it is to be seen in the broader context of other converging international initiatives to improve the investment climate, including the OECD Guidelines for Multinational Enterprises.

A partnership process

The *Framework* is being developed by a Task Force through a partnership process involving OECD Member and non-Member governments, in co-operation with civil society and other international organisations. The first plenary meeting of the Task Force took place at the OECD in Paris on 17 June 2004.

A horizontal policy approach

The Task Force agreed that the *Framework* will consist of a comprehensive stocktaking of sources of good policy practice across a range of policy areas that have been identified by international organisations involved in investment and development, and the Monterrey Consensus, as playing an important role when it comes to creating an enabling environment for investment and enterprise development.

The Task Force identified a preliminary list of policy building blocks for the *Framework*: investment policy; investment promotion and facilitation; trade policy; competition policy; tax policy; corporate governance and responsibility, and market integrity; human resource development; infrastructure development; and public governance. In addition to host-country policy action, the contribution of international co-operation, including through regional integration, and home-country policy action will also be addressed.

The work of the Task Force is supported by the Investment Committee and other OECD committees with expertise in the policy areas being considered for inclusion in the *Framework*.

Next steps

The Task Force takes advantage of the OECD Global Forum on International Investment and various regional events organised by the Investment Committee as opportunities to discuss inputs into the *Policy Framework for Investment* in both global and regional contexts. A progress report on the *Initiative on Investment for Development* was made available for the 2005 OECD Ministerial Meeting, with the aim of completing the work of the Task Force in 2006.