Workshop 1: Policy and Institutional Responses

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MULTILATERAL AGREEMENTS ON INVESTMENT AND THE ENVIRONMENT

Prof. J (Hans). B. Opschoor,
Institute of Social Studies (The Hague) and Free University (Amsterdam)

1. This conference is to address relationships between investment and the environment in the context of a globalising economy, and to suggest ways of improving this relationship in a win-win way for both investment and the environment. Within this setting, this paper focuses on some aspects of an institutional framework for promoting environmentally sound FDI, especially through multilateral arrangements relating to investments. It will deal with some economic and environmental prospects as related to OECD's views on global economic development (referred to below as the "linkage-led development (LLD)"-scenario) to 2020. The outcomes of this scenario will be put in the context of some theoretical observations. The paper will then will discuss environmental aspects related to liberalisation of investments and international investment regimes. Finally, some conclusions, as well as recommendations, will be presented. In terms of spatial scale and regional emphasis the paper deals with global processes and developing countries more than with economies in transition as such.

Globalisation, Development and Environment

Promises of Linkage-Led Development

2. Globalisation is a dominant feature of the economic realities of today (OECD 1997a-d; Pronk 1997; Emmerij 1998). It relates both to the dissemination of products, technologies, ideas etc. in a rapidly expanding domain, but also to the growing independence of enterprises of specific territorial bases and their increasing capability of servicing larger sections of world markets. OECD believes that closer linkages between states or economies, notably through trade and investment, will promote mutually beneficial economic growth. In fact, "... a dramatic increase in global prosperity would be in prospect" (OECD 1997d). This is so, despite the fact that globalisation is often "... blamed for unemployment, income inequality, ... environmental degradation and the marginalisation of a number of developing countries" (OECD 1997c).

3. OECD (1997d) has explored several scenarios of plausible global economic futures until 2020, including a "high-performance scenario" (HPS) of accelerated growth and a "Business as Usual" (BaU)-scenario.

4. In the HPS-scenario trade will increase more than 1.5 times as fast as production, especially in the non-member economies) and with a large increase of OECD-NME-trade. With HPS, world GDP will grow by 227 per cent between 2020 and 1995; almost twice as high as would be the case in a business as usual development. Per capita income in the world would rise by close to 60 per cent in BaU, and with almost 2.5 times as much in the high performance scenario. Incomes per capita would rise with 100-150 per cent in developing countries, and even with 270-340 per cent in the case of high performance growth. Development promises rapidly rising material standards of living and a better share in world income generation. development promises rapidly rising material standards of living and a better share in world income generation. Essentially, linkage-led development promises rapidly rising material standards of living and a better share in world income generation and trade to many developing countries and economies in transition - especially the ‘big five’: Brazil, China, India, Indonesia, Russia.

5. The environmental and possibly some distributional impacts may be less promising. Here I will focus on environmental issues, especially that of climate change as induced by changes in the levels of carbon concentrations in the atmosphere. Carbon emissions will rise to nearly 2.5 times the 1990 level (of 6 gigatonnes), in 2020. In the BaU-scenario, carbon emissions would grow too, to 10 billion tonnes, but the high-performance scenario adds almost 5 billion tonnes to that. This is 25 per cent above the level accepted implicitly in Kyoto level. Such levels undermine the multilateral efforts in this area related to the Framework Convention on Climate Change and the direction it is taking since Berlin and Tokyo.

6. For the high performance scenario to materialise major changes in the global economic environment are to expected to be necessary, including:

- very rapid trade liberalisation: zero tariff-equivalents in 2020;
- rapid liberalisation of investments and elimination of capital controls (“deepening of economic integration”).

7. The benefits in terms of trade and income, then, can be obtained only at the “price” of substantially increased linkage between the economies of the OECD and the rest of the world. This includes linkage in the form of deep penetration through direct and portfolio investment *etc.*, which may reduce options to societies or states to have control over their own economic development strategies.

8. OECD (1997a) does recognise (*inter alia*) that: globalisation could negatively affect countries’ scope for national action (impact on governance), and may lead to increased tendencies towards (environmental) cost shifting onto others (and the future) due to increased competition and the need to be competitive. OECD therefore emphasises that co-operative programmes should be designed to deal with regional and global environmental issues in a globalising environment, including Multilateral Environmental Agreements (MEAs).

Some Theoretical Observations

9. Leaving aside, for the time being, the trade-offs between economic growth and environmental degradation, the effects of linkage-led development in the High Performance Scenario appear compatible with expectations in international economics.

10. If countries attempt to maximise welfare and if welfare is captured adequately by a proxy such as national income or product, trade intensification would raise the welfare levels of *all nations concerned*, due to a more efficient exploitation of comparative advantages related to the (given)

distributions of factors of production over countries. This would be so if certain conditions on the existence and functioning of markets and market parties are met. When these are not met, market failure is said to exist. Generally accepted causes of such market failure are current and intertemporal external effects (including, notably, environmental externalities), undesirable distributional repercussions, instabilities in the economic process (for a more detailed analysis of institutional failure by the present author, see Opschoor 1996).

11. Market failures may lead to situations where the welfare implications of enhanced international trade become ambiguous (as in the case of externalities). Globalisation will bring much more economic activity within the domain of (deregulated) markets and hence within the reach of international competitive forces. This might lead to more environmental externality as firms might feel induced to shift part of their social (environmental) costs on to society at large, by-passing or evading environmental legislation. Countries might even feel induced to allow such cost shifting by deliberately keeping their environmental standards low and/or by abstaining from enforcing existing regulations, at the expense of environmental quality later. In fact, one could argue that, in the absence of internationally agreed basic environmental standards and without well-defined and protected rights (property, or access) in relation to environmental quality and natural resources, free trade may enhance inequality and unsustainability.

12. In a dynamic setting, welfare may be enhanced by raising the levels of factor availability or of factor productivity (*e.g.* by domestic investment, learning, increased factor mobility). Here, the latter element, that of factor mobility, is relevant. Mobility of factors will tend to reduce differentials in remuneration of the mobile factors and hence eliminate the extent of comparative advantages; absolute advantage given any remaining constraints on mobility will then determine to a larger degree flows as well as levels of trade. Traditionally (*e.g.* Ricardo) factor mobility (labour, capital, natural resources) was regarded to be generally low for natural or cultural reasons. Normatively, some outstanding economists have argued that this was to be considered preferable, also where finance is concerned[1]. This had to do with the preservation of the notion that nations would need some control over their economic basis if they are to remain viable communities (Daly 1996).

13. If free mobility of factors such as capital is possible and is allowed to take place independent of some form of societal control over it, an allocation might result that is closer to one based on absolute advantage. This might lead to a larger world product, but now, unlike in the case of the welfare argument based on comparative advantage, *not all nations involved would be better off*. In fact, some might lose considerably. Factor mobility does enhance efficiency and production, but not necessarily the welfare distribution.

14. FDI leads to increased levels of domestic production, often through companies of which the equity is internationally owned in whole or in part, in national economic settings. This gives international investors access to the environmental 'spaces' of these countries (*i.e.* their natural resources and their environmental 'sinks' for wastes and pollutants). By importing protected technologies and skills, such firms could even have a competitive advantage in exploiting these national environmental spaces and thus reap the rents associated with their immobility. More generally, in the absence of proper markets for many natural resources and for access to environmental sinks, and in the absence of adequately effective environmental institutions, both the efficiency and sustainability of the use of resources and sinks may be low, leaving the national stakeholders with much less of a future resource base than is justified in an intertemporal perspective. Intertemporally, FDI may erode comparative advantage in natural stocks and sinks and create new comparative disadvantage. One specific example of such possible behaviour would be that of TNCs locating their environmentally sensitive activities in countries with low levels of environmental policy, thereby stimulating the emergence of pollution havens (most likely in developing and emerging countries); empirical evidence so far does not seem to bear this out. The unsustainable use

of natural resources is another example, but here too, unsustainability is not to be associated solely with the non-national origin of the investment: empirical research would be needed to detail the balance in specific cases between national and internationally based economic activity in terms of its resource impacts.

Linkage-Led Development: a Preliminary Assessment

15. Linkage-led development holds a promise of substantially increased material welfare, but may also be expected to come with some important negative impacts, such as environmental ones. So far, liberalisation has often been accompanied by environmental degradation. In many developing countries liberalisation has led to manifestations of marginalisation and exclusion and associated environmental degradation (see *e.g.* reports on the short-term effects of structural adjustment programmes). Furthermore, the implications of GATT/WTO and NAFTA in cases of environment-economy conflicts (and the results thereof for the position of national environmental policy and law) can be rather negative when looked at from an environmental perspective. development promises rapidly rising material standards of living and a better share in world income generation.

16. Often the hope is expressed that growth in per capita income would generate an inverted U-shaped pattern of environmental impact, thus ensuring that, beyond some threshold value of income per capita, environmental pressure would drop with rising income (the so-called 'Environmental Kuznets Curve'). Empirical research has cast doubt on the notion that extended growth in per capita income would lead to on-going reductions in environmental impacts of economic activity. This may be the case for some pollutants or materials and resources used, but not for all, and the overall effect might in several industrialised countries already show an upswing (see, *e.g.*, De Bruyn and Opschoor 1997). This can be explained by the 'volume'-impacts of growth on environmental pressure overshadowing the positive results of increased environmental efficiency per unit of product or activity.

17. Under conditions of imperfect and incomplete markets, changes in production and consumption patterns as envisaged may enlarge the occurrence and the effects of market failures such as social costs including environmental costs, in addition to their alleged and proudly presented positive impacts. In fact, such linkage-led development may give rise not only to more and differently distributed externality-related environmental costs today, but even to new intertemporal comparative disadvantages in cases where future relative dispositions of natural capital stocks are affected by sell-outs and cost shifting. The ultimate results of linkage-led, accelerated globalisation are a matter of empirical investigation: there is no *ex ante* answer to the question of the net impacts on human welfare. Adverse environmental repercussions may be significant. To the extent that this is the case, one may well agree with Sai-wing Ho (1998), that, "if unrestricted trade with, or unrestricted investment from, the North could adversely affect the development of the South, the obvious implication is that the South should strive for some controls over these activities."

Investment Agreements

18. The theoretical considerations and the empirical evidence quick-scanned above suggests that it may be in the interests of states and governments to have a degree of oversight and influence over capital flows entering and leaving their economies, and on how they impact on the productive capacities of these economies. On the other hand, some of the features of globalisation (*e.g.* the mobility in legal and administrative terms of TNCs) has rendered that increasingly difficult. In what follows, some information

is presented on recent developments with respect to capital flows, and on the history of the regulation of such flows.

Some Background on Capital Flows

19. In the period from 1970 to 1985, LDCs increased their shares in global current account transactions but hardly participated in international capital flows (Luttik 1998).

20. The fluctuations in capital flows in that period were much more pronounced than those in the current account.

21. More recently, capital flows have developed as follows (Scholtens 1998).

- Aid flows (grants) have remained fairly constant around $30 billion (recently with a slight tendency to decline), whereas official loans went down from approximately US$25 billion (1990) to less than US$20 billion (1997). Overall official flows went down from around US$60 billion (1990) to US$36 billion in 1996/7; this is due especially due to a drop in bilateral ODA. To put this in perspective: overall official capital flows were approximately US$40 billion at the end of the 1980s.

- Private capital flows have grown tremendously: from about US$45 billion in 1990 to close to US$250 billion in 1997. Especially FDI and loans (incl. bonds) have grown sharply, with FDI now being around 45-50 per cent of total private flows (Gentry p. 15). The share of equity (portfolio investments) went from virtually nil to US$25 billion, or around 19 per cent (1996; Gentry), and fluctuates significantly. Ten countries in particular benefit from this, and absorb over 75 per cent of this. Two of these (China and India) are low-income countries; the other eight are middle-income countries such as Mexico, Brazil, Argentina, Indonesia, Thailand, Russia.

22. The rate of growth in these private flows dropped in 1997, largely due to a decline in flows to East Asia/Pacific (especially in shares) and less so in FDI; debts/bonds continue to grow there.

23. One issue relevant in the context of this Conference is, whether one can expect significant environmental aspects to be associated with FDI. Conversely, it is of interest to know to what extent the volume of FDI is influenced by national environmental policies in the receiving countries. Based on a range of empirical case studies in Latin America, Gentry (1999) concludes that:

- most FDI is in manufacturing and services, giving rise to very different environmental considerations than investments in resource extraction; specifically, improved environmental performance occurs when this enhances access to export markets, improves production efficiencies, maintains a social licence to operate, and helps obtain finance;

- integrating environmental considerations into investment attraction programmes does *not* drive away FDI investors;

- such integration, as well as environmental policy and subsidy cuts on other grounds, all lead to environmental investments in manufacture that is economically justified and/or generates support for implementation of policies across the board so as to level the playing field.

- influencing portfolio investments (equity and bonds/loans) for environmental reasons is much more difficult than in the case of FDI.

24. Empirical observations such as Gentry's appear to be in line with the cost differentials that are associated with environmental regulation. In many industrialised countries these differentials appear to be very small (typically in the 1-2% range, within a wider sectoral spectrum). They also are in line with the absence of environmental regulation in criteria that determine locational decisions by internationally operating firms.

Regulation of Capital Flows

25. The issue of the regulation of international investment came up earlier in this century (below, I follow Schrijver, 1995). It has always been seen as related to the exploitation of natural resources. International regulation of investment was biased in favour of the capital-exporting countries, intending to provide investors with a maximum of freedom of movement of capital. Essentially, early regulation protected an investor against arbitrary expropriation and guaranteed treatment above or at a minimum international standard as well as due process of law. Early discussion on this came from Latin America: the Calvo Doctrine of around 1900 according to which foreign investment was to be treated equally before the law of the country in which investment takes place and there should be abstinence from interference by 'home states.' This view was never generally accepted. At the most, some elements of it penetrated into subsequent agreements (*e.g.* the 1962 Declaration on Permanent Sovereignty over Natural Resources is a mixture of national and international standard).

26. More recently there has been a spectacular growth in bilateral investment treaties between states. However, this became felt to be non-transparent and potentially inefficient. Hence the climate has shifted in favour of a multilateral approach. In 1991, the Development Committee (a joint ministerial committee of World Bank and IMF) requested the World Bank to develop a legal framework for the promotion of FDI. The subsequently developed guidelines on the treatment of FDI included some interesting features, such as:

- the guidelines are proposed as a complement to (*not* a substitute for) applicable bilateral and multilateral treaties and other international instruments;

- each state maintains the right to make regulations to govern the admission of private FDI; performance requirements are not ruled out, but it is suggested that these are not desirable; open admission (subject to generic restrictions) is proposed as a more effective approach.

27. Since 1988, a functioning Multilateral Investment Guarantee Agency (MIGA) has existed, based on a Convention extending coverage to investments in cases where investors comply with laws and regulations of the host country, and where fair and equitable treatment and legal protection of investments are ensured.

28. Thus, in a somewhat longer time frame, the dichotomy of international and national standard is still relevant. Schrijver (1995) concludes that: ".... it would be relevant to include the main rules of modern international investment law in a global multilateral investment convention", "... , centred around 'permanent sovereignty, international economic co-operation and international arbitration arrangements...".

The Recent MAI: some general observations

29. OECD has been involved in designing a multilateral agreement on investments (MAI). In line with its preference for linkage-led development as elaborated in the HP-scenario discussed above, MAI would have enhanced free capital mobility. In this paper, the history of that MAI will not be detailed; it may suffice to observe that, in October 1998, this effort came to a halt, at least temporarily, due to some governments' objections to elements of the MAI as then tabled. Apart from problems with the substance of the then proposed MAI, objections have been raised regarding the process by which it came about: process seemed preferable by which developing countries would be more explicitly involved. The latter tendency may lead to a situation in which organisations other than OECD may ultimately pursue the issue of multilateral arrangements for capital flows and investments (*e.g.* WTO, UNCTAD, IMF, or even a new multilateral mechanism such as an open convention), if the issue is reopened. In this section of the paper, the focus is on some environmental features of the MAI as discussed so far, especially its environmental repercussions. The objective is, to draw some lessons that might pertain if and when the issue of a multilateral approach to the regulation of capital flows emerges again.

30. Basic features of the MAI as recently discussed in OECD are the principles of 'national treatment' and 'most-favoured nation treatment'. Moreover, it entailed what could be referred to as 'investment security' as another principle, pertaining to *e.g.* the conditions of expropriation, dispute arrangements and the outflow of returns to investments. Essentially, the agreement entitled foreign corporations to buy, sell and (re)locate without constraints, plants, resources, assets and other properties, on the same legal conditions as domestic corporations. Binding arbitration of disputes was foreseen, both between states and between investors and states, by an MAI Arbitral Panel.

31. As already suggested, a fundamental argument in favour of a multilateral arrangement of this nature is that this would possibly be fairer and more transparent, as well as more efficient than a multitude of bilateral arrangements. Against this, and the economic gains expected of it, some critics expressed concerns over the fundamental change in balance of powers between state and economy[2]; to multinationals MAI would have given more rights, and in fact fewer duties[3] and investors' rights were put central and foremost. There were other objections but these do not concern us here, except some points related to environmental aspects.

MAI and Environment

32. Concerns expressed over environmental aspects of the MAI as proposed, include some general points and some more specific ones.

1) The more general observations include:

2) The environmental consequences of more FDI in a liberalised, globalising context, are not undisputed - as suggested by the expected GHG emissions.

3) In such a context, competition for investment may lead to standstill, rollback or non-enforcement of national environmental legislation and to the 'sell-out' of natural resources.

4) A fundamental problem with increased investment in a context of globalisation/liberalisation is the implicit assumption that private corporations are becoming responsive enough to leave environmental legislation/standard setting to the private sector and to NGO lobbying. This assumption is absolutely unproven and no more than an article of faith.

5) MAI would have facilitated international access national stocks of natural resources to exploitation by transnational enterprises and by foreign capital, and might in fact even give a competitive advantage to firms able to bring in international technology and management experience. There is a fear that this would allow such investors to appropriate rents on these resources and to put pressure on national governments to much more rapidly sell out these resources than is compatible with sustainable development, thus potentially hampering future development prospects.

6) Secondly, in many ways MAI seems to have been modelled on NAFTA, and NAFTA's performance in terms of environment-investment dilemmas is not undisputed from an environmental perspective. Cases referred to frequently include: Ethyl Inc. *vs.* Canada[4], METALCLAD against Mexico[5], Myers Inc[6].

33. Some more specific points raised are related to:

1) National Environmental Policies

It is important that regulations pertaining to capital mobility and investments do not stand in the way of the evolution of national policies and legislation in the environmental domain. With respect to the MAI as discussed recently, there was a concern over 'standstills' on policy development, and over 'roll back' effects on existing regulation. Given the stage of maturity of environmental policy in many countries - not only in the developing countries or transition countries - the perspective of sustainable development should be paramount.

2) The relationship between MAIs and MEAs

The UNCED conference of 1992 (Agenda 21 and the Rio Declaration) has some outcomes relevant to the issue of international capital mobility. In the first place it underlines, again, the sovereign rights of nations to exploit their own resources. Secondly, it formulates 'principles' such as 'polluter pays', 'precautionary behaviour, 'differentiated responsibilities', 'internalisation of environmental costs.' UNCED also underlines the crucial role of investment in achieving growth and sustainable development, including FDI and the transfer of technology. Such principles and the notions of fairness and partnership that permeated the UNCED-documents, should, from a perspective of sustainable development, be given a prominent role in any multilateral arrangement for FDI; it was felt that this was not incorporated in MAI drafts as were developed in 1998.

Prior to, and in the wake of UNCED, several multilateral environmental agreements have come about (*e.g.* on ozone, waste, climate change, biodiversity) and more will follow. These MEAs sometimes have discriminatory stipulations as a consequence of the "common but differentiated responsibilities" of nations. For instance, the Convention on Biodiversity mandates 'benefit sharing of profits from the exploitation of genetic resources'; climate convention arrangements might include the sharing of emissions mitigation credits; Montreal leads to unequal levels of responsibilities in terms of funding and technology transfer. The relationships between such arrangements and multilateral economic agreements should be unambiguous.

34. Those developing arguments such as those presented above, are not necessarily against liberalisation or for fundamentally rolling it back. Rather, it is tantamount to a plea for a more pragmatic

and perhaps precautious approach to globalisation and to the regulation of it . Elements of such an approach as put forward by many key participants in the debate over investment agreements, include:

- a gradual approach to submitting economies to globalisation and competition;
- the explicit and profound integration of environmental issues in multilateral economic agreements;
- selectivity in allowing FDI into certain sectors;
- regulation of the volume of financial capital.

In Conclusion

35. There has never been more market than now. There therefore has never been more risk of market failure. These risks are larger in terms of probabilities, and, even more so in terms of events (and the impacts thereof) in the case of extra growth in economic activity as induced by liberalisation. If one is, with OECD (*e.g.* 1997a-d), concerned about the possible implications of unqualified and unchecked liberalisation, one cannot be against a MAI of some sort: some framework agreement on international investments and capital mobility is desirable, if not necessary.

36. In the perspective of liberalisation, the need to control speculative capital is accepted by some, whereas many would argue to open up economies more for real, direct investments. But given the existence of significant market imperfections this may lead to patterns of investment and production that are not desirable in that market conditions do not adequately allow for the internalisation of social (including environmental) costs and government policies so far in all countries fail to enforce this.

37. If such impacts can be expected to be large, options to control capital flows need to be considered. Again, in the (neo-) liberal approach, this would translate mainly into a concern over the quality of the national financial institutions and the monitoring of their performance. Some might wish to go beyond that, and either ask for more specific controls by international institutions, or for a restoration of national controls (Daly 1996). This paper argues that controls by (accountable) national governments should not be given up or weakened too easily.

38. A multilateral framework for investments might be a very desirable institution, if it protected and furthered a social and environmental market economy, and could present a check where globalising economic forces pursuing their short-term and private goals at the expense of long term and public considerations. Such an arrangement should be open for a forward looking approach to codes and standards on firms and their transactions and should deal seriously with concerns over the sustainability of the ‘scale’ of prevailing and anticipated patterns of production and consumption from a global as well as national perspective. That would imply that the relationships with the multilateral environmental agreements (old and new) should be clear.

39. As empirical evidence begins to show, developing and emerging economies should not fear that more explicit or even more stringent environmental regulation at the national level would keep out or drive out FDI. Incorporating environmental concerns in multilateral agreements would minimise that risk even further.

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NOTES

1 As Keynes once said: "... let finance be primarily national" (1933)..

2 For instance: *(i)* the right of (unrestricted) entry; hence the end of protection of domestic/local industries ("no more Koreas"); non-discrimination; *(ii)* banning of "performance requirements" (criteria on length of stay, job creation, *etc*.) and national treatment; *(iii)* an MAI-tribunal takes over powers of arbitrage and perhaps effectively of setting standards (WTO experiences in cases such as EU resistance against US hormones and NAFTA case of Ethyl Inc *vs*. Canada); *(iv)* governments can be taken to this court; no reciprocal right to sue by governments; *(v)* Standstill on legislation that violates MAI-rules, and on new country-specific non-conforming measures; possibly reversal of burden of proof before products or standards are accepted, to US/UK system; *(vi)* possibility of enforced rollback even when reservations have been submitted; *(vii)* end of right of trade retaliation or boycotts.

3 E.g.: *(i)* No discrimination: National Treatment and Most Favoured Nation Treatment; *(ii)* restriction/prohibition on nationalisation; *(iii)* disadvantage for SME; *(iv)* assets can be moved more easily which e.g. could undermine union power; *(v)* no more restrictions on degree of equity ownership by investors; *(vi)* easing of corporate accountability laws: possibly ban on linking receipt of public benefits to specific conditionalities on corporate behaviour.

4 Canada wished to ban the transportation and trade of MMT (a petrol additive) that allegedly posed significant health risks. Use is prohibited in California. Ethyl Inc sued Canada (because a ban on sales would be tantamount to depossession in relation to foregone anticipated profits) for US$251 million. Canada settled out of arbitration for US$13 million, plus the right of Ethyl to trade MMT, plus the statement that MMT poses no health risks.

5 METACLAD Co protested against Mexican measures (based on new ecological facts) against M opening a waste disposal plant. M claimed US$90 million in damages on grounds of seizure of potential profits now lost.

6 Myers Inc (Ohio) plans to submit a claim to Ottawa under NAFTA for compensation for the 1995 ban on PCB export.