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Policy Framework for Investment
A review of Good Practices

Chapter 1

Investment Policy*

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1.1. Introduction

This chapter 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. The purpose of this chapter is to examine how investment policy contributes to an environment that is attractive to investors and that enhances the benefits of investment to societies. It serves as background documentation for the investment chapter of the *Policy Framework for Investment*.

Sections 1.2 and 1.3 examine two principal aspects of investment policy that support an attractive investment environment; transparency and protection. Section 1.4 focuses on international investment issues, with particular attention to non-discrimination and the role of international investment agreements.

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 chapter 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 chapter 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.

1.2. Transparency

What steps has the government taken to ensure that the laws and regulations dealing with investments and investors, including small and medium sized enterprises, and their implementation and enforcement are clear, transparent, readily accessible and do not impose unnecessary burdens?

The Monterrey Consensus 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).

Transparent information on how governments implement and change rules and regulations dealing with investment is a critical determinant in the investment decision. Transparency and predictability are especially important for small- and medium-sized enterprises that tend to face particular challenges to entering the formal economy. It is also important for foreign investors who may have to function with very different regulatory systems, cultures and administrative frameworks from their own. A transparent and

Box 1.1. **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?

predictable regulatory framework dealing with investment helps businesses to assess potential investment opportunities on a more informed and timely basis, shortening the period before investment becomes productive. The importance of transparency and predictability has thus motivated a number of initiatives, such as the OECD Framework for Investment Policy Transparency, that aim to help governments to achieve greater transparency. Transparency provisions have also been enshrined in virtually all modern international investment agreements, including the agreements of the WTO, regional agreements such as the NAFTA and most bilateral investment treaties of recent vintage.

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.

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

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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, including with respect to investment approval mechanisms, and their possible review can serve to bolster confidence in the regulatory framework for investment.

OECD surveys on progress with respect to regulatory reform have found that performance is still far from satisfactory. The twelve OECD 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.

Common transparency-related problems and possible solutions are outlined in Box 1.2. These provide policy-makers with more detailed, operational criteria for consideration in answering the overarching question posed at the beginning of this section.

Box 1.2. **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.

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Box 1.2. **Transparency and predictability in investment policy: from principles to action** *(cont.)*

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.

1.3. Protection of property and contractual rights

As quoted from the Monterrey Consensus in the introduction to the previous 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. 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 also holds relevance from a broader 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."

The protection of such rights, within the broader context of efforts aimed at developing a sound legal framework and judiciary system,[1] 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.[2] With respect to the protection of investment, two broad policy areas stand out.[3] These are; 1) the promotion and protection of property rights, and 2) contract enforcement, including timely and adequate compensation for expropriations.

1.3.1. The promotion and protection of physical property rights

What steps has the government taken towards the progressive establishment of timely, secure and effective methods of ownership registration for land and other forms of property?

Secure, transferable rights to agricultural and other types of land and other forms of property are an important pre-requisite for a healthy investment environment and an important incentive for investors and entrepreneurs to shift into the formal economy. They are also a fundamental element in building a credible corporate governance framework (for further details, see the chapter on corporate governance). They entitle the investor to participate in the eventual profits that derive from an investment and reduce the risk of fraud in transactions. These rights carry an intrinsic economic value and investors need to be confident that their entitlement to these rights are properly recognised and protected. Well-defined and secure ownership, including effective register of what constitute public properties, encourages new investment and the upkeep of existing investments. Land titles, for example, give an incentive to owners to promote productivity enhancing investments. Reliable land titling and property registrars also help individuals and businesses to seek legal redress in case of violation of property rights and offers a form of collateral that investors can use to improve access to credit. Improved access to credit lowers one of the main obstacles to new investment, especially among small and medium-sized enterprises.

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.[4]

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 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.[5]

On a larger scale, the example of the Compania Peruana de Teléfonos (CPT) 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.[6]

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 1.3 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 1.3. 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 implementation.
2. A strong policy, legal, and institutional framework was in place for land administration.
3. The project built on earlier efforts to issue documents recognising 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.

1.3.2. The promotion and protection of intellectual property rights

Has the government implemented laws and regulations for the protection of intellectual property rights and effective enforcement mechanisms? Does the level of protection encourage innovation and investment by domestic and foreign firms? What steps has the government taken to develop strategies, policies and programs to meet the intellectual property needs of SMEs?

Intellectual property rights give businesses an incentive to invest in research and development, and ultimately lead to the creation of innovative products and processes. They also give the holders of such rights the confidence to share new technologies, such as in the context of joint ventures. Successful innovations are in time diffused within and across economies, bringing higher productivity and growth. Investment is thus, both a pre-condition for the creation and diffusion of innovation activity. The intellectual property right protection instruments used by governments to encourage investment in research and development include patent and copyright laws, which give the owner, for a pre-determined period of time exclusive right to exploit the innovation. How effective these instruments are in terms of encouraging investment in innovation activity also depends on how well the rights are enforced. Efforts to curb non-compliance, for instance counterfeiting, are therefore an important feature of any intellectual property regime. At the same time, intellectual property right regimes need to strike a balance between society's interests in fostering innovation and in keeping markets competitive and, especially in the case of essential medicines, in sufficient supply (see also chapter 4 on competition policy and question 8.5 of the chapter on human resource development).

A modest increase in the value managers expect to realise from patenting new products has been found to boost R&D by anywhere from 11 per cent in the biotech industry to 8 per cent in the pharmaceutical industry to 7 per cent 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 1.4.)[7]

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

Box 1.4. **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.

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 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.

- The intellectual property rights regime is not only a matter of concern to large firms and multinational enterprises with significant research and development programmes, but also to small and medium-sized enterprises (SME). SMEs are a driving force behind innovation, yet their potential to invest in innovation activities is not always fully exploited. SMEs tend to under utilise the intellectual property system, partly due to their lack of awareness. (On the promotion of investment by SMEs, see also the chapter on Investment Promotion and Facilitation.) Measures that extend access to the intellectual property regime system may thus help to attract investment in research and development and to transmit the positive spillovers to society that such investment embodies. Governments can help by, for example: promoting a greater use of the intellectual property system; developing specific 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 intellectual property-related services to SMEs; and by providing information and advice on intellectual property issues to SME support organisations.

1.3.3. Contract enforcement[8]

Is the system of contract enforcement effective and widely accessible to all investors? What alternative systems of dispute settlement has the government established to ensure the widest possible scope of protection at a reasonable cost?

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.

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 less than 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.

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.[9]

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.

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.

1.3.4. Timely and adequate compensation for expropriation

Does the government maintain a policy of timely, adequate, and effective compensation for expropriation also consistent with its obligations under international law? What explicit and well-defined limits on the ability to expropriate has the government established? What independent channels exist for reviewing the exercise of this power or for contesting it?

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 appropriatecompensation."

Notwithstanding the widespread acceptance of the need for timely, adequate and effective compensation, the power of government to expropriate raises policy issues that

Box 1.5. **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 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 health, safety, and environmental 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.

* Some agreements use alternative wording when it comes to compensation, often with a view to providing clearer guidance on what should be considered prompt (*e.g.* without undue delay), adequate (*e.g.* fair market value), and effective (*e.g.* fully realisable and freely transferable).

Source: OECD (2005), "Indirect Expropriation" and the "Right to Regulate", *International Investment Law: A Changing Landscape*.

usually involve a careful balancing of interests and judgement on the part of policy makers, in addition to the inherent negative impact of expropriation on the investment climate. To avoid negative effects on the investment climate, governments are encouraged to consider whether similar results can be achieved through other public policy means. If a government decides to expropriate land or other property, this decision ought to be motivated by a public purpose, observe due process of law, be non-discriminatory and guided by transparent rules that define the situations in which expropriations are justified and the process by which compensation is to be determined.

Some recent agreements provide that except in rare circumstances, 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 expropriations. However, governments need to remain mindful that, consistent with longstanding international norms, certain regulatory action may constitute expropriation.

1.4. The international dimension of investment policy

In addition to the level of transparency and protection afforded to investors in the context of the domestic regulatory and legal framework, the quality of a country's investment environment is also strongly influenced by its international investment-related commitments. This section considers first the issue of non-discrimination before turning to some of the specific contributions of international investment agreements (IIAs) to the quality of a country's investment environment.

1.4.1. Non-discrimination

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.[10] 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.

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National treatment and MFN

Has the government taken steps to establish non-discrimination as a general principle underpinning laws and regulations governing investment? In the exercise of its right to regulate and to deliver public services, does the government have mechanisms in place to ensure transparency of remaining discriminatory restrictions on international investment and to periodically review their costs against their intended public purpose? Has the government reviewed restrictions affecting the free transfer of capital and profits and their effect on attracting international investment?

The non-discrimination principle provides that all investors, both foreign and domestic, are treated equally.

The concept of "national treatment" provides that a government treat enterprises controlled by the nationals or residents of another country no less favourably than domestic enterprises in like situations. The OECD Code of Liberalisation of Capital Movements, for instance, provides that non-resident investors 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.

The divergent approaches to national treatment across countries reflect governments' "right to regulate". Subject to specific commitments made in international agreements (see Box 1.7), 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 chapter on competition policy, and aside from the delivery of some public services, 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).

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 1.6). 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.

Box 1.6. **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).

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 home grown.

Policies that favour some firms over others (*i.e.* any policies that derogate from national treatment or MFN) involve a cost. They can, for instance, result in less competition and efficiency losses, thereby damaging the investment environment. For this reason, exceptions to non-discrimination need to be evaluated with a view to determining whether the original motivation behind an exception (*e.g.* protection based on the infant industry argument) remains valid, supported by an evaluation of the costs and benefits. A broad consideration of the costs and benefits is especially important in service sectors that support a wide range of economic activities across the economy (*e.g.* telecommunications).

For a firm to be able to make, operate, and maintain investments in another country, the ability to transfer investment-related capital, including repatriating earnings and liquidated capital, is important. Many governments allow such free transfers, albeit without prejudice to their ability to take measures to prevent evasion of tax and other applicable laws and regulations and policy measures aimed at addressing serious balance of payment difficulties in accordance with their rights and obligations under their international investment agreements. Measures that restrict transfers can adversely affect investor confidence and, concomitantly, inflows of international investment.

1.4.2. Making the most of international investment agreements

Are investment policy authorities working with their counterparts in other economies to expand international treaties on the promotion and protection of investment? Has the government reviewed existing international treaties and commitments periodically to determine whether their provisions create a more attractive environment for investment? What measures exist to ensure effective compliance with the country's commitments under its international investment agreements?

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 2 332 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 developed and developing countries, reflecting the perceived mutual benefits of investment promotion and protection.

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, 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.

One of the most important contributions of international agreements to the investment climate consists in the enhanced confidence these can provide foreign and domestic investors beyond the level of confidence the government has already promoted through credible domestic commitments. International agreements promote investment in much the same way as the protection of title to property encourages investment (as described in sections 2 and 3 above). International agreements tend to make it more difficult for governments to change certain policies since these are now part of a broader package of international commitments (*e.g.* a "single undertaking" like the NAFTA contains binding commitments on trade, investment, services, and a range of other issues important to investors). This involves some foregone policy flexibility for the government that undertakes such commitments. However, it also makes the regulatory environment faced by investors (both domestic and foreign) more predictable. For example, many

Box 1.7. **Performance requirements in international agreements**

Provisions are often included in international agreements that place limits on the ability of governments to impose performance requirements on firms. The WTO TRIMs Agreement and the NAFTA investment chapter are two prominent examples which have influenced provisions in BITs and other agreements containing investment provisions.

The WTO's Agreement on Trade-Related Investment Measures (TRIMs) recognises that certain investment measures can restrict or distort trade and provides that "*no member shall apply any TRIM that is inconsistent with the provisions of Article III* [National Treatment and Internal Taxation and Regulation] *or Article XI* [General Elimination of Quantitative Restrictions] *of GATT 1994*".[1] The Agreement's Annex contains an illustrative list of prohibited measures which include, *inter alia*, local content requirements and trade-balancing requirements imposed on an enterprise.

BITs and investment provisions in trade agreements. Provisions on performance requirements included in IIAs have been generally based on the TRIMs Agreement and NAFTA. This latter agreement provides that the parties may not, either in the pre or post-establishment phase, impose or enforce any commitment or undertaking requiring investors to export a given level or percentage of goods or services; to achieve a level or percentage of domestic content; to purchase, use or accord preference to goods or services provided in the territory; to restrict sales of goods or services; to transfer technology; or to act as exclusive supplier of good or services to a specific region or world market. Other agreements such as Japan-Korea BIT prohibit additional measures such as requiring to locate the headquarters of the investor in its territory; to achieve a given level or value of research and development in its territory; or to hire a given level of its nationals.[2] Exceptions to the application of performance requirements may also be included in these agreements.

1. See WTO TRIMs Agreement Article 2
2. See Japan-Korea BIT Article 9.

international agreements dealing with investment contain limits on the use of trade-related investment measures (TRIMs), such as balance of payment or trade-balancing requirements. TRIMs tend to discourage investment by imposing costs on firms (indeed, this is why they often go hand in hand with various incentives to invest). By agreeing to limits on the use of TRIMs in international agreements, the risks and uncertainty associated with these policy instruments is reduced (see Box 1.7).

Another important feature of international agreements concerns the channels through which disputes are resolved. Many international agreements dealing with investment, including most recent BITs, contain provisions that allow disputes between investors and host country governments to be resolved through international arbitration. For example, the International Centre for Settlement of Investment Disputes (ICSID), established in 1966 and with 155 signatory states,[11] allows firms from one member state to pursue their investment disputes against other member states through binding international arbitration. Just as a sound domestic system for contract enforcement promotes investment by bolstering the confidence of investors that their contractual rights are secure (see the section on "Contract enforcement" above), commitments made in international agreements giving recourse to impartial channels of international arbitration provide an additional layer of protection to investors and, most importantly, signal a government's commitment to the rule of law. Also relevant in this regard is the United Nations Convention on the Recognition and Enforcement of Arbitral Awards (the New York Convention), which makes arbitral awards rendered in one party to the Convention enforceable in any other party to the Convention.

Has the government ratified and implemented binding international arbitration instruments for the settlement of investment disputes?

A key feature of international agreements concerns the channels through which disputes are heard and resolved. Most international investment agreements contain provisions by which governments consent to permit investors to seek the settlement of investment disputes with the host country government through binding international arbitration (sometimes in limited instances contingent upon provisions on the exhaustion of local remedies). These commitments, giving recourse to impartial channels of dispute settlement, provide an additional layer of protection to investors and, most importantly, signal a government's commitment to the rule of law, bolstering the confidence of investors that their property rights are secure (see also questions 1.2 and 1.4). International arbitration is carried out through *ad hoc* or institutional instruments, *e.g.* pursuant to the 1966 Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention). The Convention has been ratified by 143 states and is supported by the International Centre for Settlement of Investment Disputes (ICSID) which), which administers arbitration proceedings under international investment agreements. The ICSID Convention provides for a self-contained mechanism, including enforcement. For non-ICSID arbitral awards, the 1958 New York Convention for the Recognition and Enforcement of Foreign Arbitral Awards makes arbitral awards rendered in one party to the Convention enforceable in any other party to the Convention and has been ratified by 135 states. There is a need to extend support for government capacity building for treaty negotiation and handling to governments that lack experience in dispute settlement.

Governments, including those in all OECD member countries, also consider that additional transparency in investment arbitration, in particular in relation to the publication of arbitral awards, subject to necessary safeguards for the protection of confidential business and governmental information, is desirable to enhance effectiveness and public acceptance of international investment arbitration, as well as contributing to the further development of a public body of jurisprudence. They generally share the view that, especially insofar as proceedings raise important issues of public interest, it may also be desirable to allow third party participation, subject however to clear and specific guidelines.

Notes

1. Including civil law, commercial law, codes of civil procedures, company laws, civil execution laws, etc.
2. See World Bank (2004), p. 79.
3. As originally identified in World Bank (2004), p. 80.
4. World Bank (2004), p. 80.
5. World Bank (2004), p. 84.
6. See De Soto (2001), The Secrets of Non Success (*www.cato.org*).
7. The link between intellectual property protection and competition is also addressed in the competition policy chapter.
8. This section focuses on contract enforcement in the domestic context. Section 1.4 extends the discussion to contract enforcement through international channels.
9. World Bank (2004), p. 88.
10. Conversely, reverse or positive discrimination measures, whereby foreign investors are treated more favourably than domestic investors, are also frequent when countries compete by means of preferential financial and other incentives to attract FDI. The issue of incentives is addressed in the chapter investment promotion and facilitation.
11. Of which 142 had ratified the Convention as of 25 May 2005.

References and Further Policy Resources

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