iisd International Institute for Sustainable Development
Institut international du développement durable
http://www.iisd.org

Towards A Southern Agenda on Investment

Summary of Country Studies and Some Observations

May 2004

Published by the International Institute for Sustainable Development.

The International Institute for Sustainable Development contributes to sustainable development by advancing policy recommendations on international trade and investment, economic policy, climate change, measurement and indicators, and natural resources management. By using Internet communications, we report on international negotiations and broker knowledge gained through collaborative projects with global partners, resulting in more rigorous research, capacity building in developing countries and better dialogue between North and South.

IISD's vision is better living for all—sustainably; its mission is to champion innovation, enabling societies to live sustainably. IISD receives operating grant support from the Government of Canada, provided through the Canadian International Development Agency (CIDA) and Environment Canada, and from the Province of Manitoba. The institute receives project funding from the Government of Canada, the Province of Manitoba, other national governments, United Nations agencies, foundations and the private sector. IISD is registered as a charitable organization in Canada and has 501(c)(3) status in the United States.

International Institute for Sustainable Development
161 Portage Avenue East, 6th Floor
Winnipeg, Manitoba
Canada R3B 0Y4
Tel: +1 (204) 958-7700
Fax: +1 (204) 958-7710
E-mail: info@iisd.ca
Web site: http://www.iisd.org/

Table of Contents

1. Introduction

Central to the IISD attempt to initiate the process of articulating a Southern Agenda on Investment that promotes sustainable development is the contribution of five country studies undertaken by four partner institutes.

It turns out that the questions posed by IISD in the terms of reference were quite demanding in that they called for a more integrated approach to FDI, domestic investment policies, and international investment agreements than has generally been undertaken. This puts into stark relief one of the underlying premises of this project: that effective policies to promote international investment that supports sustainable development can only be crafted if all of these factors are taken into account. It also puts into equally stark relief the challenges ahead in meeting this goal.

Among the challenges that such analyses pose is the need to integrate economic and legal analysis with an understanding of the policy environment for sustainable development. The five studies received represent a remarkable first approach to these complex issues. They provide important insights and lead to a number of follow-up questions that are arguably even more difficult to answer. This note summarizes some of the results of the studies and articulates some follow-up questions with a view to promoting further debate about the research and policy requirements for international investment regimes that promote sustainable development.

2. Five Country Studies

Working with largely similar terms of reference, the five studies develop a range of information, analysis and conclusions. This is presumably a reflection of differences in the policy environment of each country, differences in the—sometimes scant—research base the authors could draw upon, and differences in analytical approach to a multidisciplinary set of questions.

2.1 Argentina

A large proportion of recent FDI flows into Argentina trace their roots to privatization or mergers & acquisitions. From 1989 to 1993, Argentina went through a period of vigorous liberalization of its domestic investment regime, followed by a large-scale privatization program. At the same time, the Republic became an enthusiastic adherent to international rules on foreign investment: signing a multitude of bilateral investment treaties and making extensive commitments under the WTO's agreement on services.

Information about the environmental and developmental impacts of Argentina's enhanced FDI flows is more difficult to come by. While Argentina has rigorous environmental regulations, the enforcement of these regulations leaves much to be desired. This appears to be aggravated by a lack of clarity as to the enforcement responsibilities of various institutions and agencies. In terms of the environmental performance of newly privatized firms, there is little data available at present. Argentina has cracked down in an effort to ensure that tax revenues are not lost as a result of questionable transfer pricing practices by foreign multinationals and their local subsidiaries, however in common with many such efforts, it is unclear to what extent these efforts have yielded results.

Special regimes have been created to attract foreign investment in several sectors, notably mining, automobile manufacturing, and forestry. However, while the regimes have provided sufficient incentives and flexibility to attract new investment, they have not succeeded in creating broad linkages to the domestic economy. Firms often source internationally, which may promote efficiency whilst having an inimical impact upon local firms. Indeed, one overall policy lesson which emerges from the Argentine experience with FDI is that "developing countries attracting significant FDI inflows should not take for granted that domestic firms will automatically benefit from the presence of TNCs." As Roberto Bouzas and Daniel Chodnovsky warn, domestic linkages will be contingent upon the absorption capacities of local firms. Accordingly, they call for "public policies aimed at fostering such capabilities (i.e., to promote the use of skilled labor and modern EM in SMEs, the undertaking of in-house innovative activities, the networking between the agents and institutions of the National Innovation System, the development of value chains, etc.)."

Following the Argentine financial crisis, and the devaluation of the Argentine Peso, a large number of foreign investors objected to a series of emergency measures put into place to mitigate the impacts of the crisis. Many investors in the public utilities sector found themselves squeezed as they carried large external debtloads denominated in US dollars, yet collected revenues in devalued Pesos – and were forbidden to raise prices charged to consumers. A long string of these disputes have led to some thirty international arbitrations being launched by foreign investors under the terms of international investment treaties. The Argentine Attorney General's office has objected strenuously to these arbitrations, arguing that the disputes should be resolved within the Argentine legal system. In each case heard so far these objections have been rejected by the arbitral tribunals. Concerns have also been raised about the constitutionality of Argentina's adherence to an external system of investor-state arbitration – a system which was acceded to with little or no public debate or appreciation for its policy implications.

2.2 Brazil

Brazil has a long history of welcoming foreign investment. This liberal attitude towards FDI has been a consistent feature of Brazilian economic policy, even as the trade regime was subject to a good deal of fluctuation. By and large, investment into Brazil has been market seeking, and continued in times of high trade protection since the domestic market was sufficiently attractive. The 1990s saw growth of FDI, often precipitated by privatization of many state-owned assets. A considerable amount of FDI in the 1990s was in the services sector, catering to the domestic market.

Special regimes set up to attract investment in auto manufacturing and IT appear to have had some success. This may, however, come at the cost of allocation distortions and rent-seeking behaviour on the part of firms in the auto sector which are protected from external competition.

It is clear that international investment treaties do not play a significant role in attracting investment. Indeed, Brazil has yet to ratify any of the small number of such agreements which it has signed over the years, so that its international commitments on investment are limited to two WTO agreements on services and trade related investment measures.

The relationship between recent FDI inflows and the balance of payments has been the subject of debate in Brazil. Some FDI involves takeovers of Brazilian firms, which then turn to foreign suppliers that have established relationships with the new owners, – importing inputs and exporting comparatively less. This results in fewer spin-offs for domestic firms and sees less diffusion of technology throughout the host state. In addition FDI into non-tradable services can impose continuing burdens on the balance of payments as profits are exported.

Notwithstanding Brazil's attraction of significant foreign investment flows, there appears to have been surprisingly little research examining the concrete impact of such investment upon sustainable development in Brazil. Likewise, data on foreign investment's contribution to larger goals such as poverty reduction is also lacking.

Relative to the size of its economy, Brazil does not export much investment. This reflects a low level of integration of most indigenous firms into the global economy, or a focus on products that can be traded at arms length and do not require foreign investments to support sales, service and development. The government has set up an office to promote Brazilian investment abroad.

2.3 South Africa

The South African experience affirms that investment treaties are not a necessary prerequisite for large-scale investment to take place. In the post-Apartheid period, the United States has been the largest foreign investor in South Africa; this investment has occurred without the benefit of a bilateral investment treaty between the two countries. Historically speaking, the UK has been the largest foreign holder of South African capital stock; much of this foreign investment also took place without benefit of a bilateral investment treaty (the UK-SA treaty was concluded only after Apartheid had come to an end).

Although Post-Apartheid South Africa has created a very open investment regime – with no minimum capital requirements or prior approval needed to establish a local business presence – the country still under-performs in terms of attracting its fair share of inward FDI. A host of factors may help to explain this under-performance – from the unsettling fact that domestic businesses appear to be sitting on large cash-holdings to a variety of macro-economic factors. These various factors serve to remind that mere liberalization will rarely be a sufficient condition for attracting significant inward investment.

Indeed, there is an active role for the state to play. Government midwifery has proven important in attracting investment, with some 20% of total inflows attributed to government efforts at promotion and facilitation. Government has also been credited with working to ensure that investment gains are shared by historically disadvantaged minorities and blacks. Here, however, it is notable that international legal commitments in South Africa's roster of investment treaties could complicate efforts to craft Black Economic Empowerment policies. Only some of South Africa's treaties enter exceptions for policies designed to further racial equality in the country. Those which do not would seem to raise concerns that such treaties could complicate efforts to impose BEE policies upon foreign investors where such policies may contravene a treaty protection. This concern is compounded by the fact that dispute settlement under these treaties may be conducted under a cloak of secrecy. While at least two investor-state disputes are understood to have been mounted against South Africa, full details of neither are publicly available, and there is no ability to confirm their relationship to proposed BEE policies.

Looking at the potential positive spin-offs of foreign investment, it can be exceedingly difficult to quantify some of these. As the Trade Law Center for Southern Africa notes, direct employment creation may be easier to calculate, but "it is virtually impossible to accurately quantify in terms of intellectual capital, skills development and transfers of know-how, and backward linkages into the local economy."

2.4 Malaysia

Malaysia has no general investment law and inward investment is closely screened and channeled so as to serve domestic economic and social goals. The absence of a domestic investment law provides greater discretion to authorities in reviewing and licensing investment applications. In this respect, Malaysia differs markedly from the other countries surveyed for this paper, particularly Argentina and Brazil. Nevertheless sectors designated as priorities have seen sizable inflows thanks to carefully-crafted incentives and good infrastructure.

Malaysia has concluded a sizable number of bilateral investment treaties, but has yet to negotiate one with its largest inward investor, Japan. From the available information it appears that Malaysia, in keeping with the ASEAN approach that focuses on investment promotion measures, has not accorded rights of market access. Over time, Malaysia has moved away from its bias towards those investments that could be expected to boost exports, and dismantled performance requirements which conditioned ownership rights upon export requirements. Following the Asian financial crisis, restrictions on foreign ownership in the manufacturing sector were lifted in an effort to stimulate new inward investment.

By and large, investment policy has tended to be guided by industrial policy, with incentives designed to encourage new investment in priority industries. Although FDI has had a significant impact upon the development of the Malaysian economy since the mid-1980s, there is little data on the degree of technology transfer and the creation of linkages to domestic firms. While Malaysia has a series of regulations governing environmental management, and a requirement to undertake environmental impact assessment, TDRI cautions that weak institutions and unclear enforcement responsibilities have meant that compliance is not always optimal.

Malaysia has ensured that its investment policies are consistent with its long-standing program which earmarks special privileges for ethnic Malays and other indigenous groups (Bumiputras). In recent years, however, policies reserving minimum equity stakes to bumiputra investors have been abolished in the manufacturing sectors, but persist in others.

2.5 Thailand

Significant FDI Inflows started to pick up for Thailand in the second half of the 1980s, following an earlier move away from a focus on import substitution and towards an export-led economic strategy. Following the Asian financial crisis in the late 1990s, further liberalization was undertaken in an effort to attract new foreign investment. While considerable liberalization has occurred in the manufacturing sector, the services sector still remains quite closed to foreign investment.

Thailand operates an extensive program of incentives designed to attract foreign investment, however it is unclear how effective these incentives are once you take into account their costs. Indeed, in the view of the Thailand Development Research Institute, a full-scale cost and benefit analysis of incentives should be a priority exercise. There are also suggestions that some fiscal incentives may have been superfluous; one study found that some 70% of investments would have gone forward even in the absence of the various tax incentives which had been granted. Due to a divided political structure, the authorities charged with granting these and other incentives are not the same authorities responsible for revenue collection. As a consequence of this disjunction in official roles, there may be a tendency to disburse incentives (including tax holidays) far more readily than if a single body were charged with both functions. It is notable, however, that Thailand has seen some success in regional economic development, thanks to the provision of greater incentives to foreign investors for locating in under-developed areas. However, such incentives are insufficient to sway investor decisions in instances where there is inadequate infrastructure to support new investments in these targeted areas. This points to the necessity of public investment in such infrastructure to correct what amounts to a failure of market forces. Moreover, it should be noted that foreign investors typically seek to locate in areas as close to the most highly-industrialized region as possible, while still laying claim to incentives for parking themselves in an under-developed region.

In terms of the impact of FDI upon development objectives, studies show foreign firms operating in Thailand do tend to pay higher wages. Likewise, some technology transfer can be identified, although it tends to be of the lower-order technologies (product technology, quality control, etc.). Interestingly, some skepticism has been expressed about the diffusion of technologies thanks to the future job mobility of those employed by foreign firms; according to one survey such employees tend to take new jobs with other foreign employers, rather than with local firms, precisely because these foreign employers pay wages.

Broadly speaking, Thailand's international investment treaties are not as far-reaching as those concluded by many other countries. The bilateral investment treaties do not enter into any additional liberalization commitments (i.e. there are no pre-establishment commitments), nor do the treaties provide for a functional international dispute settlement mechanism; Thailand has yet to ratify the Convention of the International Centre for Settlement of Investment Disputes (ICSID), thus depriving foreign investors of the use of the only investor-state arbitration option listed in its bilateral treaties. Thailand is a party to the ASEAN agreements on trade and investment. The latter contains significant investment commitments, including pre-establishment access and a functional investor-state mechanism. Apart from Singaporean investment, Thailand receives little FDI from its ASEAN partners.

Thailand's approach to international investment agreements appears to reflect what might be termed an "ASEAN approach," that is a focus on investment promotion to reduce the chances for unfair competition between ASEAN countries for investors and to increase the ability to attract very large investments that are too big for any one of the countries.

3. Some Observations

The five country studies will help to identify a range of issues that require further elucidation. This initial listing is designed to promote discussion at the regional workshops, where it is anticipated that a range of additional issues will be raised and perhaps initial hypotheses for further analysis identified.

3.1 Integration of FDI with Domestic Investment Policies

As a matter of principle, all policies that apply to domestic investors—including those designed to ensure satisfactory environmental management and to promote sustainable development—apply equally to foreign investors. Consequently domestic investment policies are in practice an integral part of policies towards foreign investors. Yet the manner in which the full suite of domestic laws and policies interact with the international agreements is often not fully considered when the agreements are made. Some signs of the reversal of this sit6uation are at hand: in particular some more recent agreements now articulate a policy of non-derogation from at least environmental and labour standards in order to attract investment, two critical elements relating to overall investment and development directions.

Countries compete for investment—and jurisdictions in most countries also compete amongst each other. Consequently international investment agreements must increasingly also serve the purpose of ensuring that this competition occurs in a manner that is fair and transparent and that respects the needs of global public goods.

3.2 Disorder of International Obligations

Most countries have entered into a range of international investment agreements that reflect a wide variety of assumptions concerning the appropriate content of such agreements and even concerning the most appropriate manner in which certain issues such as Non-discrimination or expropriation are to be defined. Frequently developing countries have signed model agreements presented by different developed countries; there has been little coordination between countries concerning the model agreements that they use. Some countries have changed their model agreement over the years, often for reasons that have not been made transparent, yet have not acted to bring older agreements into conformity with newer ones. The result is a degree of confusion that varies from country to country but can certainly be the source of significant uncertainty as to the scope and meaning of agreements. This situation is at the very least paradoxical in light of the emphasis of many proponents of these agreements that they are needed to promote certainty.

The most favoured nation principle poses some difficult issues in the current situation of heightened uncertainty. It remains unclear to what extent investors can "cherry-pick" provisions in all BITs—or even in all investment agreements—signed by a country. This issue arises whenever a country has two IIAs with different formulations for the same issue. Recent cases support the view that it is unlikely pre-establishment rights can be inserted from one investment agreement into another that does not contain any by means of MFN provisions, yet there is actually nothing in the MFN principle that clearly excludes such a practice. At the very least once a country has accorded pre-establishment rights in one agreement it will make it much harder to refuse to do so in others it may seek to negotiate.

The European Union has begun a process designed to ensure that BITs signed by Member states are in conformity with EU law, leading to the renegotiation of a significant number of BITs. Yet the broader questions concerning an overall approach to international investment agreements are not being discussed. Nor has the question of why the provisions in these agreements should be proper for developing countries or economies in transition, but not for OECD countries themselves been raised in an significant way.

3.3 Investment in Forestry, Fisheries and Agriculture

The five country studies are remarkably sparse when it comes to information concerning foreign investment in forestry, fisheries and agriculture. To some extent the implicit model of FDI revolves around investment by large transnational corporations, which focus mainly on production and marketing of industrial products[1]. In many countries foreign investments in these sectors are not large enough in broad economic terms to merit special attention. Yet these are highly sensitive areas from the perspective of sustainable development and a number of instances are known where such investments have proven particularly problematic[2]. Moreover investor practices in the home country are nowhere more germane to decisions concerning their treatment than when it comes to investments that lead to the modification of the natural environment.

It has sometimes been postulated that the liberalization of agricultural trade that is now under negotiation will permit the development of international product chains controlled by major actors in the relevant commodity, for example seed producers, traders or large food processors. The result would be a significant increase in international investment in these sectors.

[1] Yet *Volkswagen do Brasil* at one stage invested heavily in Amazon real estate so as to benefit from tax concessions offsetting their profits from the automobile business that were available at the time.
[2] Joint EU/Argentine investments in the fisheries sector are believed to have contributed significantly to problems of over-fishing in Argentine waters. Similarly investments by Malaysian forest products companies in Africa have been the subject of concern.

3.4 Relationship with Services Agreements

It is often said that the General Agreement on Trade in Services (GATS) is in fact an investment agreement, at least insofar as the so-called "mode 3" is concerned. While the word "investment" does not occur in the GATS[3], it clearly has implications for foreign investment and creates certain framework conditions for international investment agreements. Investment disputes exhibit a tendency to migrate towards the investor-state process rather than towards the WTO dispute settlement system, even when investments in services are at issue. The former offers investors the prospects of compensation whereas the latter offers a change in rules that have caused the dispute, with the threat of countervailing action that does not, however, benefit a harmed investor. It is probably necessary to assess the system of services agreements to understand a country's investment obligations.

3.5 Trade Liberalization and Investment Openness

It appears axiomatic that trade liberalization and increased openness to investment are but two different positions on a continuum of liberalization. Yet there has been limited analysis of the relationship. In the case of efficiency-seeking investment, trade openness is certainly critical. But in the case of market-seeking investment this is much less obviously the case. Once an investor has invested in a country, the investment will benefit from closed markets and the possibility of associated rents like any other economic citizen of that country. Consequently a more complex situation appears to exist than the relatively straightforward linkage that is implied by many observers.

3.6 FDI and Poverty

Surprisingly little literature exists on the relationship between investment and poverty alleviation. Clearly investment can only benefit those who participate in markets, as employees, traders, or purchasers of goods and services. Benefits to those outside markets or on their fringe—those in the subsistence economy and the poor—are at best very indirect whereas the possible costs, for example through loss of access to land, are likely to be direct. Frequently the investments most important to the poor are public investments that benefit society at large—for example education and public health—rather than private investments that must generate adequate financial returns. An additional set of issues exists when investments are made in essential services such as water supply, sewage, and certain energy services. The poor are in great need of such services yet they are unable to pay market prices. Devising institutions capable of addressing the needs of the poor in these sectors is one of the more important challenges facing investment negotiators.

---

[3] One participant in the negotiations has stated that this is the result of a conscious effort to avoid the use of "investment" in the GATS, resulting in the concept of "commercial presence," which some observers consider equivalent. This kind of subterfuge creates significant problems when it comes to interpreting the resulting text.