Master thesis:

Foreign Direct Investment in legal perspective

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Nadia Rakili
24 June 2013
## List of abbreviations

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<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>Agreement on Trade Related Intellectual Property Rights</td>
<td>TRIPS</td>
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<td>Bilateral Investment Treaties</td>
<td>BITs</td>
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<tr>
<td>European Commission</td>
<td>EC</td>
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<td>European Court of Justice</td>
<td>ECJ</td>
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<td>Free Trade Agreements</td>
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<td>Friendship, Commerce and Navigation</td>
<td>FCN</td>
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<tr>
<td>General Agreement on Tariffs and Trade</td>
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<td>General Agreement on Trade in Services</td>
<td>GATS</td>
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<tr>
<td>International Centre for Settlement of Investment Disputes</td>
<td>ICSID</td>
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<td>Multinational corporations</td>
<td>MNCs</td>
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<tr>
<td>Multilateral Investment Guarantee Agency</td>
<td>MIGA</td>
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<td>North American Free Trade Agreement</td>
<td>NAFTA</td>
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<tr>
<td>Organization for Economic Co-operation and Development</td>
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<td>Trade-Related Investment Measures</td>
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<tr>
<td>United Nations Commission on International Trade Law</td>
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<td>World Trade Organization</td>
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Introduction

Foreign Direct Investment

The new legal discipline “Foreign investment law” (FDI) is principally developed since the 1990’s.¹ Foreign investment is important as one of the key forces of economic growth and development.² There are two opposite perspectives with respect to foreign investment. Firstly the Calvo doctrine that tells us that foreign investment leads to damage of the host states. The other perspective is pro foreign investment, in the sense that it states that foreign investment leads to numeral benefits to host states.³ It can be divided in foreign direct investment and foreign indirect investment. FDI means that an entity from one state invests physically in another state, usually called the host state. This includes investing in machinery, related corporate assets and also includes equipment and building a factory. The difference with foreign indirect investment is that the latter one is about portfolio investments in local companies by foreigners, where no control of the local investment occurs.⁴ I will focus on FDI in this thesis and I will discuss it in legal perspective.

The World Bank showed to be interested in the link between law and development. Provisions of technical assistance and funding regarding legal reform programs became supported by bilateral and multilateral aid organizations and regional development banks. A legal system consists of the officials and institutions engaged in the establishment and implementation of law.⁵ One of the major issues for international business law is the regulation and accountability of multinational companies and other foreign investors. There is a need for international law which is binding that also can successfully control and regulate FDI. There is urgency for jurisdictions to ratify legislation which address the detailed issue of foreign direct liability for multinationals. From the point of view of host nations an accurate balance between protection of national interests and the creation of attractive foreign investment region is important. The central part of law regarding FDI is about this accurate balance.

There must be a balance between the costs and benefits of law obstacles regarding foreign investment. Obstacles are not only and always bad, they can serve a national interest. Indigenous

¹ International business law II, syllabus, p. 1.
cultures, workers’ safety, health and environment are such examples of national interests which are protected through law obstacles. It’s called the “prisoner’s dilemma” of regulators of foreign investment in the host states. The question is how to attract foreign investors, while at the same time preserving national interests? This question will be the main focus of this thesis. These are obstacles that influence the attraction of investors. To begin with the banking system which can be not enough developed. Wiring and exchanging money can be heavy due to procedures. For the enforcement of contractual and property rights effectiveness of the judicial system is needed. If there is no effectiveness it will cause troubles. Another issue is that there is a lack of transparency in licensing approval and monitoring. This approval and monitoring goes often also very slow. Transaction costs increase in case of corruption regarding giving licenses. Furthermore, the unforeseeability of repatriation restrictions is a problem and tax rates and import duties can be obstacles to invest. There must be a balance between protecting national interests through legal rules (can be stumbling block to foreign investors) and stimulating beneficial FDI.

My question:

What is the role of law in foreign direct investment and how to create a legal framework that will have a positive effect on foreign direct investment?

To answer this question I am going to start with a brief overview about FDI in Chapter 1. I will tell more about restrictions relating to FDI and the liberalization of FDI. In Chapter 2 I will set out FDI in a legal perspective and in Chapter 3 I will focus on the international laws and regulations regarding FDI. Chapter 4 will contain my conclusion with an answer to my question.

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Chapter 1: Foreign direct investment and liberalization

§1.1 Foreign Direct Investment

Before starting to tell more about FDI in relation to (international) law, it is important to briefly describe FDI. FDI can be seen as a long-term investment by an entity from one country in an entity in another country (host country). FDI nowadays includes also the direct achievement of a long-term management interest in a company outside the investing company’s home state, through for example investment in a joint venture or strategic alliances with local companies. FDI includes “Greenfield” investments, direct investments in new facilities or acquiring existing ones. The purpose of these investments is to enhance connection to global investment markets and to encourage development and research in host states. This can decrease the market share of domestic competitors as they are not able to operate well. It is also possible that domestic competitors produce products and services with a lower quality leading to a declining market share.

FDI is important as one of the key forces of economic growth and development in developing countries. There are some people who are skeptical about the relationship between FDI and economic growth. The next paragraph will contain more about this criticism. It is important to notice that direct foreign investment does not only bring money, but also leads to an introduction of new management skills, formation of relations in the world market and transfer of technology. It also leads to new goods and services and the increase of productive capacity and employment. FDI helps the integration of economies. International and domestic laws and legal institutions play an important role in the growth of FDI. Furthermore, the extent of FDI inflows depends on financial development, the contribution of which is dependent on the political situation of the receiver. If there is a higher political stability the advantages of FDI can be obtained more efficiently. Dutta and Roy mentioned that the stability of politics and an efficient financial sector are a positive attractor of FDI.

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Through FDI private capital gets relocated elsewhere with capital flows and external productivity effects as a result. One can bring knowledge to a host country, which one extracted from research development. Also training for employees can be transported. All of this brings economic growth. Despite this, in empirical literature there is no unanimity regarding the effect that FDI has on economic growth in developing countries. Some say that a host countries capacity to absorb benefits from FDI depends on several factors. The question if FDI results in economic growth can depend on trade policies, financial markets of a host country etc. The World Bank states that absorptive capacity relies upon their trade openness, levels of inflation, infrastructure and human capital. The OECD states that it depends on the developments in the area of finance, infrastructure, technology and education. Others (like Carkovic and Levine 2005), don’t agree with this. Thus, there is a difference in opinion regarding the effect of FDI on economic growth.\textsuperscript{13} Although, there is unanimity about the fact that poor institutions bring along economic distortions.\textsuperscript{14} In case of a global environment where negative economic growth is predicted to persist, FDI may however become part of the solution as investors seek new and safer opportunities and as FDI moves from the sidelines into full-on investment resourcing.\textsuperscript{15}

FDI does not guarantee economic growth according to some people. According to economic studies FDI did not lead to increasing economic growth in developing countries. Although it is known that it is able to encourage economic growth, depending on the state at stake, the nature and use of FDI and last but not least the regulation regarding FDI.\textsuperscript{16} In high-income countries FDI has led to an increase in the share of gross domestic production. There was a higher impact of FDI flows in developing countries, while FDI flows in low and middle income countries increased less extreme. Sales by MNCs of foreign affiliates were of influence for the growth of FDI. These sales exceeded the value of world trade in goods and services. Intra-firm trade amongst MNCs is more or less one-third of world trade, MNC exports to non-affiliates are another third, and the last one-third is the trade among national (non-MNC) firms. Also the growth of investment in start-up companies is increasing FDI. These investments frequently need limited start-up costs and do not require extensive outlays.


on plant and equipment. Whereas many often fail to produce profits, these investments often represent high-risk, high return investments.\textsuperscript{17}

\paragraph*{\textsection 1.2 FDI and the protection of national interests}

Now that I described FDI in a short manner, it is time to discuss the important legal aspects of it. States try to expand their regulation of FDI beyond that allowed to them under customary international law. The recently developed rights of foreign investors for protection from such allegation of state power are not easy to handle in the world of international investment, which is characterized as a dynamic world.\textsuperscript{18}

A constant concern in the field of FDI is the developing right of investors to participate in FDI in a liberalized international regime and the sovereignty of states leading to protection of national interests. International investment law is needed to take care of the problems that arise because of the conflict between liberalization of investment and state sovereignty. There must be a balance regarding fair FDI and protection of public/domestic interests and natural resources. Interests of states and investors can be in contrast but sometimes they are well-matched. Sovereign states are willing to regulate FDI on public policy grounds and circumvent the flight of investor capital from unclear, capricious or arbitrary regulatory regimes. Investors seek to protect their rights and seek long-term investment and relation with the host state.\textsuperscript{19} Various countries promote FDI and liberalize FDI because they want their domestic economies to grow. One can think of technology and communication developments and decrease of trade tariffs. Advantages for FDI are the industries that are privatized and deregulated, relaxed restrictions regarding foreign investment and acquisition, decreased tariff barriers and liberalized trade policies.\textsuperscript{20}

Nowadays investment constructions and operations are big and varied because of changes in the legal framework regarding investment. The evolving global communication, foreign investment management and technologies are key elements in the further development of FDI. Furthermore, mergers and acquisitions present an important element of FDI. In this respect, control of assets and operations are being transferred from foreign to local entities or from local to foreign entities.

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Foreign and local entities are connected to each other. Advantages arise from decreased production and supply costs, growing productivity in foreign markets and bigger operational efficiencies. The variety of investment opportunities is increasing because of FDI. One can think of mutual distributorship agreements, international portfolio management and technology and licensing transfers. It is a difficulty when domestic companies cannot compete successfully when there are acquired or merged companies at stake. Another problematic issue is the case when foreign investors bring earnings abroad.  

Countries might selectively limit FDI to protect some domestic industries from competition of foreigners. This is founded on domestic public policy basis, as argument countries bring into play the use of sovereign power. They use administrative regulations, trade and investment legislation and procedures regarding FDI. Nowadays countries have liberalized FDI more, it is not restricted to constricted grounds based on important security interests anymore. There are new manners of regulating FDI. For the protection of investors ‘rights procedures and institutions are created. Also regulatory regimes are created to limit process claims of foreign investors in the domestic interest. States are precautious about letting foreign companies establish themselves in their company and have profits, when the outflows of capital may surpass the inflows.

The advantages of FDI are known as creating economic development, making infrastructure available etc. But there are some downsides. FDI may, that is to say, menace domestic investors and interests and infringe domestic economies. Opposition to FDI has his beginning by developing countries, saying that it is an economic utilization by developed countries (think of multinational corporations in this respect). They selectively raise barriers to FDI, because this will offer them more self-sufficient politically, more self-confident culturally, and more self-reliant economically. Their resistance showed by them becoming member of multilateral entities such as the WTO. They have also concluded FTAs and BITs selectively with other states, including developed ones, based on strategic political and economic basis. Nowadays resistance towards FDI also occurs in developed countries. The first concern of developed countries was to find abroad something to put their growing investment capital in. Currently the ones that were exporters of capital became importers of capital. Developed states have restrictions on FDI now. Developing as well as developed countries are

protecting themselves from global financial and related risks, by way of putting restrictions on FDI. Countries have created more barriers pursuing the protection of their domestic industries.  

There are different host state controls over inward investment. There are restrictions that keep out such investment from the state as a whole or from particular industries/sectors. It occurs that you can invest in the host state after getting a permission that is dependent on a review process. When the foreign investment is founded, the actions of the foreign investor fall under the general law of the concerning land. Generally, the same laws are to be applied in case of foreign investors as applied to domestic companies. It is significant to see how far a host state goes in accepting international obligations to assure the entry of foreign investors to the territory of the host state. In theory the discretion to regulate the actions of foreign investors is not limited conforming to principles of state sovereignty under international law.

Should international minimum standards control the scope of this mentioned discretion? Capital exporting states are pro and capital importing states are contra. States have put themselves in international protection standards by closing BITs and FTAs (these contain investment provisions). The discretion of host states to control the entry and establishment of foreign investors is generally not limited by International investment agreements. This is to be left to host states and their law. The terms of international investment agreements will contain provisions that preserve the discretion of host states to control the entry and establishment of foreign investors. The protection of non-discrimination standards to entry and establishment by foreign investors is expanded by regional agreements as MERCOSUR, NAFTA and ASEAN, US and Canadian BITs and some bilateral FTAs. This is a liberalization aiming to expand protection of investors to the pre-entry stage before the foreign investment has been established and the actions of the foreign investors fall under the domestic laws of the host state. A large amount of the international investment agreements concern merely the post-entry stage.

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§1.3 Towards liberalization

States have several techniques to avoid domination by foreign investors of their domestic economies. These techniques occurred in the 1970s when self-determination and economic nationalism had high priority. This is also the time when in host state economies the foreign investment was high. Because of the lack of access to the most modern productive technology and to investment capital the economic nationalism costs are too much. The economically advanced states as well as the less developed states have more and more relaxed their strict investment control and foreign ownership regulation. They also putted less strict conditions on the investments. The progressive liberalization of indigenization laws is a sign. Also, investment screening laws are applied less restrictively. The outright prohibition of foreign investment policy by socialist states is almost outdated. Industrial sectors reserved for public ownership are less nowadays and this brings more opportunities to invest. Many states pursue privatization as to increase the overall level of inward foreign investment in the economy. The prohibitions on foreign investment that still exist are to be found in sectors of the national economy which are important to national security.28

If one pursues liberalization of FDI, this liberalization must bring advantages to foreign investors and also the economies of home states. FDI can be used as a manner to divert domestic profits generated through FDI into political, social and economic infrastructure. Countries encourage FDI in lower protected sectors, while limit FDI in protected sectors. By regulating FDI in the short term on a strategic basis the economic effect of FDI can be made constant in the long term. In the process of regulating FDI states strategically decide on reducing restrictions, how to reduce it and when to reduce it. They choose between competing reorganization procedures. There are several options, for example the modification of social law or tax law etc. It is possible that countries prefer FDI in the sense that goods are cheaper in the domestic market meanwhile knowing that this has a disadvantage for the local employment.29

There is a possibility that states apply regulatory practices unequally. States that attract FDI with their laws and regulations can pursue nationalization and expropriation, and as a way defeat FDI, this with a lack of due process of law. The expropriation of FDI based on public policy reasons can have a negative effect on the protection of property rights. There can be deduction of FDI by states through the statement that FDI is a “theft” of national resources. This does not imply that states make misuse of their sovereign powers while regulating FDI but the regulation can be invasive.

28 P.T. Muchlinski, Multinational enterprises & the law, the Oxford international law library 2007, p. 213-214.
Think about using the generated tax benefits from FDI for domestic economic infrastructure (that support FDI).\textsuperscript{30}

Policymakers went towards a view of stimulating the attraction of FDI, many restrictions have been eliminated. Global FDI inflows were $57 billion in 1982 and became $1271 billion in 2000. Viewing the last decades the growth rate of world FDIs has exceeded the growth rates of world trade and gross domestic product. FDI brings a lot of advantages, like the introduction of management techniques, new processes, and technical know-how in the local market, productivity gains, transfers of new technology, employee training and international production networks. FDI is less destructive as it is not unpredictable. While the theory foretells that FDI inflows bring great benefits to the host country, empirical studies showed conflicting results. Some say FDI makes an advantage to recipient states in the sense that growth effect becomes bigger but others say there is no evidence on that or there is evidence of a disadvantage in the sense of a negative effect on growth effect. Host countries must be capable to benefit from FDI flows, to accomplish this they have to have certain qualities.\textsuperscript{31} Also of importance are the development of financial markets, trade policy and the quality of human capital. For the growth of FDI institutions are also of importance, one must also think about the importance of economic activities.\textsuperscript{32}

Economic freedom is important for companies as they must be able to attract and internalize new technology from foreign companies and is important to give a boost to economic growth of host states. There is an assumption that less regulation will stimulate economic growth. A competitive and free market is more beneficial to the economy, as there are more possibilities for new ideas and companies are more open to take risks regarding FDI activities to get higher returns. If a market is extensive regarding its regulation the market would not work effective and the distribution of resources would be adversely affected. Labor laws can have an influence on the FDI flow, one can be reluctant to invest in a country and join its local firms when it applies strict labor laws. An important issue that must be considered is the protection of property rights. As country it is more beneficial to have a good protection system of property rights to attract FDI which has high technological essence. Organizations will be more open to put more effort in research and development in the concerning county they invest in. Also the freedom of exchange beyond borders has a positive influence on FDI.

countries are more able to export and get in touch with the international markets. Freedom is thus important for countries as they can benefit from foreign multinational corporations who invest in their countries.\(^{33}\)

§1.4 Conclusion

A constant concern in the field of FDI is the developing right of investors to participate in FDI in a liberalized international regime and the sovereignty of states leading to protection of national interests. As I have described in this chapter, a competitive and free market is more beneficial to the economy. Some say FDI makes an advantage to recipient states in the sense that growth effect becomes bigger but others say there is no evidence on that or there is evidence of a disadvantage in the sense of a negative effect on growth effect. Despite all this critics about whether FDI is beneficial for economic growth or not, what really matters is that countries must be capable to benefit from FDI flows by having certain qualities. The nature, use and regulation of FDI are important. If a state wants to benefit from FDI it must make these aspects FDI friendly.\(^{34}\)

International investment law is needed to take care of the problems that arise because of the conflicts between liberalization of investment and state sovereignty. There must be a balance regarding fair FDI and protection of public/domestic interests and natural resources. Interests of states and investors can be in contrast but sometimes they are well-matched. More about this topic in the next chapters.


Chapter 2: Foreign direct investment in legal perspective

§2.1 Foreign Direct Investment in legal perspective

My thesis is about FDI and the role of the legal system as determinant of the location of FDI. FDI is important for capital and technology needed for economic growth. For this goal states have an aim to attract foreign investors to invest in their jurisdiction. Development agencies and commentators sometimes argue that the legal frameworks of states have an impact on the investment flows, they can attract or deter foreign investors.\(^\text{35}\)

The new legal discipline “Foreign investment law” is principally developed since 1990’s.\(^\text{36}\) There are several important institutions. Under the leading of Dr. Shihara the MIGA was created. Also the ICSID is created. This is an arbitral institution which is leading and has global members. It resolves disagreements between investors and host countries. There is also a statement of universal standards, the Legal Framework for the Treatment of Foreign investment, affecting the policies of host countries. This can be used as foundation for a global treaty on foreign investment. It is important to look if improved laws and policies regarding FDI will raise the amount of foreign investment flows and whether the investments bring more benefits.\(^\text{37}\) A strategic and flexible approach is needed for the use of foreign investment in a beneficial manner for the national interest on the long run.\(^\text{38}\) An effective legal framework has an influence on effective strategies to decline corruption.\(^\text{39}\)

The national and international policy environment, including law and the legal system, can have an effect on the direction and flow of investment flows. The legal system can influence an investors’ perception of risks and returns of an investment positively or negatively. Raising transaction costs through application of certain laws and regulations may cause the investors to demand more returns on their investment. A lot of developing countries implemented reforms of their laws the previous years. The World Bank helped them in this and the reforms led to decline of costs and risks to investors regarding foreign investment. Also the flow of private foreign capital was

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\(^{36}\) International bussiness law II, syllabus, p. 1.


promoted. These countries had a contribution to diverse international measures, including international arbitration conventions, bilateral investment treaties, the International Centre for Settlement of Investor Disputes and the Multilateral Investment Guarantee Agency.\(^{40}\)

Many states state that they must have an effective legal system to attract foreign investors. An effective legal system is supposed to be accomplished through predictable and efficient implementation of laws. For this purpose a lot of states seek help from developments agencies.\(^{41}\) It is possible that some investors are not sensitive to the legal system and its effectiveness. Thus reforms don not affect them, because they limit their reference to the legal system.\(^{42}\) The size of an investor is important to mention. There are some who argue that large investors have negotiating power to pursue what they want or have the power to assure against the negative consequences of a legal system and thereby are likely to be less sensitive to the legal system. Others, on contrary, state that small investors are the ones who are less sensitive to legal systems as they can evade contact with legal systems of host states and can sometimes act through informal mechanisms. In addition, some state that medium sized investors are most sensitive to legal systems as they are too small to have power and too big to evade the legal system. It is also mentioned in the article of Perry that the nationality of an investor has an effect on its sensitivity to legal systems. It is shown by evidence that Western investors are more sensitive to legal systems than non-Western investors, mostly Asian investors. Asian countries are characterized by a less formalized relationship between the state and the private sector and thereby investors depend on informal mechanisms in this context. Furthermore, some assume that export oriented investors are less sensitive to legal systems as they are less influenced by the legal system.\(^{43}\)

Commentators and development agencies argue regarding the promotion of FDI in particular that “as important as what rules say is what they mean in practice. A pristine statute on investment that is unknown, unadministered and unenforced is ineffective”.\(^{44}\) The Department for International Development proposed in 1997 that it should help developing countries to implement the “right domestic policies and conditions” such as “political stability, transparent and accountable


government and the prevention of corruption,” which “are crucial in order to attract and retain both foreign and domestic investment.”45 One commentator said that Sri Lanka’s failure to attract FDI “can only be explained” by the “relative conduciveness of the investment climate,” which is made unpleasant by a lack of transparency, certainty and stability.46 Similarly, the former general counsel of the World Bank said that “a legal and regulatory framework is a fundamental element in the stability and flexibility needed for the investment environment;”47 The 1997 World Development Report states that maybe the worst damage that a state can bring to its prospects of investment is to develop an air of uncertainty,48 and the Foreign Investment Advisory Service of the World Bank group said that ineffective legal systems “increase the withdrawal of investors who may have made a preliminary decision to commit to a country.”49

§2.2 Legal framework

Developing countries moved towards policies that favor investment, which indicates the inherent advantages of foreign investment during the development process.50 In international respect foreign investment is not as harmonized as international trade law is. Also the transactions of foreign investment are until now not sound settled and defined, while international trade transactions are.51 Important international regulations of FDI are World Bank Guidelines on Foreign Investment, regional/sectoral agreements on investment, ICSID Arbitration Convention, WTO agreements, Multilateral Agreement on Investment and Bilateral Investment Treaties. I will discuss some of these in the next chapter.52

When talking about national law on foreign investment a lot of regulations are relevant. First of all there are regulations aiming to authorize and encourage foreigners to invest locally. One can think about trends stimulating liberalization and tax incentives. Also important are the regulations

48 World Bank (1997), op. cit. supra n.7, at p. 43.
52 Sheets on blackboard.
defining the forms of investment, regulations promoting and restricting the economic sectors
available for investment by foreign investors and regulations containing restrictions and promotion
issues regarding the geographical area where foreign investors may invest. There are restrictions
imposed by regulations on foreign investment, e.g. local contents, equity restrictions and real
property restrictions. There are some sectors where foreign investors can not invest because those
sectors are important for national independency and security. There are also sectors where foreign
investors can invest, but cannot exceed a certain percentage of foreign investment in that sector.
Finally there are sectors where foreign investors have a priority to invest.53

Laws and regulations can decrease returns or increase risks to investors. To start with
restriction on foreign investment entry. Approximately no country will apply an outright ban on entry
of foreign investment, but still less restrictive bans do exist (among others sectoral bans, like limits or
prohibits of having an interest in electrical power generation). The reason for these bans is
protection of public interest. Here a more critical view of countries is needed, to be carefully
regarding bans and to ask the question which national interest is protected. Besides these bans there
are also joint venture requirements and performance requirements. Joint venture requirements have
a condition that there must be local capital participation. Sometimes there are limits to the
percentage of foreign investment in a specific project. Performance requirements require a specific
functioning of the foreign investment project as condition for entry. Licensing requirements,
administrative approvals, foreign exchange restrictions, operational requirements, restrictions on
access to and use of land and natural resources and taxation are also obstacles imposed on foreign
investment.54

I have discussed difficulties that can be faced in the practice of FDI. There are obstacles
imposed by law. There must be a balance between protecting national interests through legal rules
(can be obstacles to investors) and stimulating beneficial foreign investment. Developed countries
want to impose free trade politics on developing countries, while they did not apply this in a certain
time stage when they were developing countries.55 It is shown that developed countries choose more
liberalization and non-discrimination when they develop, so these aspects are seen as outcome

53 J.W. Salacuse, “Direct foreign investment and the law in developing countries”, ICSID Review (The World
54 J.W. Salacuse, “Direct foreign investment and the law in developing countries”, ICSID Review (The World
55 H. Chang, “Regulation of foreign investment in historical perspective”, United Nations University, Intech,
2004, p. 29.
rather than as cause. In the 19th and early 20th century there was a lot of concern about foreign investments’ impact. When stating this one must consider that at that time the importance of foreign investment in the USA was less than in the developing countries nowadays, so that tells us something about the concern in these developing countries.

When the USA became world’s leading economy, a large amount of federal and state law was enacted in order to prevent loss of national control in main sectors of the economy. This legislation was focused on the main areas that were recipients of foreign investment. There is empirical evidence that shows that foreign investment regulation does not necessarily mean a decline in investment flows. Evidence also shows that countries can have a growing economy while having a strict regulation on foreign investment. Developing countries need restrictive regulation regarding foreign investment more than developed countries. Thus restrictive regulation is not by definition a disadvantage for beneficial foreign investment. The regulations regarding foreign investment must depend on the status of the international investment flows. It is not possible to have a “one-size-fits-all” foreign investment policy. A good view on foreign investment is the targeted and performance-oriented view. A country must find a balance between carrot and stick view. A combined use of carrot and stick measures lead to more beneficial foreign direct investment than using only one of the two. It is rewarding and punishing as combination for more beneficial foreign investment. Although countries have sometimes obstacles for own protection, these obstacles do not necessary have a declining effect on foreign investment. They must be proportionate, a balancing exercise must be made in this respect. Besides these obstacles there must be some degree of support to foreign investment.

Furthermore the rule of law is important for investment because it leads to a decline of risks relating to an arbitrary governmental action in host countries and a decline of transaction costs. The

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rule of law leads to predictability and thus to facilitation of investment. The key issue is that actions of governmental institutions are in line with rules known by everyone. Requirements in this respect are:

- transparency, law is known by everyone who falls under the application of the law,
- the law must apply equally and even-handedly to those who fall under the law and to whom the law is intended,
- actions of governmental institutions must be in line with specified and known rules of law,
- governmental institutions must be accountable for their action throughout a legal process.  

Laws and regulations cannot work without institutions. Institutions are the ones who bring the law in practice and thus play an important role. To start with foreign investment agencies. These agencies must focus on how to bring investments into the country and how to assist investors in getting started. The personnel of institutions must have understanding of investment and business and must have enough knowledge. There are also other executive agencies and organizations (for approvals etc). These institutions must function in accordance with laws and regulations. Courts and attorneys also have an important role in this respect. The efficiency in handling cases is important. Furthermore, knowledge is needed to understand the difficult transactions of private enterprise economy and corruption must be decreased. Additionally attorneys must be able to negotiate, plan and structure transactions for clients.

§2.3 Intellectual property law

Respect for property rights and the sanctity of contract are key elements in the context of foreign investment, the more strength they are the more a positive investment climate will be reached. The less contracts are respected the more investment is hindered. Regulations are needed for the confidence in markets and for the protection against fraud, coercion and abuse. Intellectual property law creates and protects individual property rights. It also contains rules for the transfer of the intellectual property. The following rules are important in this respect

- The International Union for Protection of Industrial Property of 1883 (Paris Convention)
- The International Union for the Protection of Literary and Artistic Property of 1886 (Bern Convention)

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WTO agreement on trade related aspects of intellectual property rights

There are signals that making intellectual property rights stronger can be an effective way of encouraging foreign investment inward. But it is important to notice that intellectual property rights do not play a role alone but together with other factors. There are complementarities between intellectual property rights, technology development policies, market liberalization and deregulation and competition regimes. Stronger intellectual property protection may be needless for attracting foreign direct investment. Strong protection of property rights of foreign investors is not needed when a country does not have the ability to copy the technologies etc. of the foreign investors and if the country does not have a large market needed for economies of scope and economies of scale. Protection of intellectual property can be seen as an important part of a difficult innovation system. This innovation system is a mechanism for economic development. A good intellectual property system is important for economic development.

§2.4 FDI regulation in international perspective

Information extracted from the United Nations Conference on Trade and Development show that laws on investment changed in the sense that there became more liberalization and less restriction in this area, even though there still can be restrictions for strategic reasons. Host states opened the doors for foreign investors starting with the elimination of burdensome administrative measures that are needed in the context of getting an approval for the investment. It is also of importance that there are no requirements of control, ownership or performance as a condition to entry. The climate can be made more attractive to foreign investors by privatization and deregulation that will create new opportunities for investment. Also special economic zones can be created for investments that are focused on export. There are benefits for inward investment like fiscal benefits etc. Also a lot of national laws that affect foreign investors can be composed in a way that will attract foreign investors. States conclude BITs and FTAs and guarantee hereby that investors do not get

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66 Sheets on Blackboard.
disturbed in their private property. The contracting parties must respect the minimum standards of the treaties. But notwithstanding this whole there are still sectors that are kept out from foreign investment. If there are no privileged dispensations the “national treatment” apply to foreign investors. National treatment means that locals and foreigners must be treated in the same way, equally. Foreign investors must thus follow national laws that are applicable in the land of investment. Foreign investors are not totally free to invest or act as they please.\(^\text{72}\)

The Code for the liberalization of Capital Movements made members of the OECD eliminate restrictions on inward investment. Some member states have made reservations in this respect, the UK and US are the most liberalized member states.\(^\text{73}\) There are two reasons for the creation of incentives to attract foreign investors. First of all, it is about a possibly reduction of risks for the investor. Secondly, host states can benefit from foreign investors perhaps in the sense that jobs can be created or development and research increases. There are income tax incentives and incentives in the form of direct subsidies. There are also market concessions, improvements of infrastructure and lower regulatory standards. This is what is been used by countries that are not really attractive on a pure economic basis.\(^\text{74}\)

The policies regarding investment incentives are bearing the risk of not attracting the useful, long-term investments that should be attracted. Short-term opportunistic investors should be circumvented, those who disinvest when the advantages from the incentives end.\(^\text{75}\) An incentive based policy can have the distortion of the international economy as a result. Competition regarding incentives to foreign investments bring along policies that are protectionist, particularly when there is less internationally mobile capital. State aids to invest hamper the trade between member states of the EC and are not allowed as state aids in the sense of Article 87 of the Treaty of Rome, thus they are contrary to the provisions of Article 87 of the Treaty of Rome. There is no such thing as a general international regulation regarding public subsidies to investors that are excessive. Competition regarding investment incentives is assumed to continue as far as countries believe that their shortcomings in inward investment locations will be compensated by fiscal and other investments.\(^\text{76}\)

Developing countries are the most harmed here as they lack often the ability to pay for the foregoing of revenue and do not always have the money for subsidies. They may feel obliged due to an incentive race with other locations for FDI. Market distorting performance requirements are subject to international disciplines under the WTO TRIMs agreement and similar rules in other regional and bilateral agreements. Investment incentives in general are not save where subsidies are used to encourage export oriented investment. They can be in contradiction with the WTO Agreement on Subsidies and Countervailing Measures. An imbalance in regulating market distorting investment policies still exists because developing countries apply performance requirements or use export oriented trade subsidies, meanwhile developed countries apply local and production oriented investment incentives. In the next chapter the international laws and regulations will be discussed.

§2.5 Conclusion

Although countries have sometimes obstacles in regard of protection of their own interests, these obstacles do not necessary have a declining effect on foreign investment. They must be proportionate, a balancing exercise must be made in this respect. Besides these obstacles there must be some degree of (national) support to foreign investment.

Restrictive regulation is not by definition a disadvantage for beneficial foreign investment. The regulations regarding foreign investment must depend on the status of the international investment flows. It is not possible to have a “one-size-fits-all” foreign investment policy. A good view on foreign investment is the targeted and performance-oriented view.

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Chapter 3 International laws and regulations

§3.1 FDI in international perspective

In this chapter will discuss several international laws and regulations regarding FDI. Some state that investment treaties differ and that treaties that protect more will bring more investment flows. The effect of Treaties on FDI is a volume of significant intellectual value that represents the definitive treatment of this most controversial issue within international investment law. FCN treaties give each contracting party the guarantee that investors have the freedom of entry and establishment. Furthermore, Japan and US had several bilateral agreements in the 1990’s to create more open market access for investors. The BITs of US and Canada assure non-discrimination in the pre and post-entry stage, including the right to found an investment. The NAFTA focuses on ensuring free access for investment and trade while the participating states keep the national power of economic regulation (under the conditions of the national treatment principle). The European Internal Market of the European Community has a single common market as goal, which will be ruled by harmonized supranational regulations. Another objective is also the creation of an economic and monetary union. They both focus on economic convergence. The NAFTA contains provisions you normally do not find in a simple free trade agreement. It also contains provisions on services, investment, intellectual property and bilateral dispute settlement mechanisms. The NAFTA can be seen as a ‘halfway house to a North American common market’. I will elaborate on this topic in this chapter.

Dispute settlement in international perspective is also of importance. International investment tribunals put effort in improving unequally considered and fractured applied international jurisprudence. It has helped creating an investment law body that intermediate between investors ‘rights and difficult interests of states. It is not possible to expect that they come with a coherent and sustainable regime for regulating FDI when there is no supportable institutional fabric. This so called fabric is in the hands of states that must know that liberalization of FDI does not only benefit foreign investors but also benefits them. States must be aware of the fact that the multilateral end product is probably bigger than the sum of the different state parts, if the sovereignty of states is an advantage to the multilateral community (foreign investors).

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79 P.T. Muchlinski, Multinational enterprises & the law, the Oxford international law library 2007, p. 238-239.
To achieve that the multilateral community is better informed about the mechanisms and means regarding the regulation of FDI, an international investment secretariat is needed. This secretariat can encourage states to engage in the formulation and application of international investment law. The secretariat can be allowed to define inconsistencies, complexities and delays in resolving FDI investor-state disputes and to offer logistical support dealing with these matters of difference to prevent conflicts. It also could work together with investment bodies founded under existing conventions such as the ICSID, the WTO and regional treaties like the European Union and NAFTA in the reform of international investment law.\textsuperscript{81}

\section*{§3.2 EC treaty}

The EC treaty does not allow restrictions on the freedom to supply services and the freedom of establishment for natural and legal persons with a Member State nationality. No restrictions on direct investment between Member States are allowed. Regarding operations of companies or firms, Article 48 of the EC Treaty provides:

"Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this chapter, be treated in the same way as natural persons who are nationals of Member States. The right of establishment, as it applies to companies and firms, includes: the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the chapter relating to capital."

Article 55 of the treaty makes Article 48 also applicable to services. One can establish a new company in another Member State or move an existing one to another Member State (primary establishment). It is also possible to establish a subsidiary, office or branch (secondary establishment). The ECJ in \textit{R v HM Treasury, ex p Daily Mail and General Trust plc} states that concerning primary establishment, moving of the control and the central management of a company to another Member State, whereas this company keeps the status of incorporation under the legislation of the first Member State, does not amount to establishment in the sense of Article 43

and 48. If there is no harmonized Community law in this respect the home state has the ability to create national law concerning the effects of such move. It is also important in this context to notice that the ECJ states that the establishment of a national of home Member States must not be deterred. This applies also to a company under its legislation with a central administration, registered office or principal place of business in the Community. If this is not the case, the rights guaranteed by Articles 43ff would not have significance.  

Host Member States must guarantee that foreign companies will be treated exactly the same as national companies of the host Member States. The establishment of an agency, a branch, subsidiary or office happens more often. A host Member State must not set discriminatory provisions restricting the choice of a legal form for the intended activities. If a company wants to enter a host Member State throughout secondary establishment ways, it is important that it shows a real and continued relation with the economy of a Member State to meet the criteria of being a beneficiary of this right. There must be an established place of business. The ECJ case law of recent days makes it possible that a company set up in any member state is allowed, even though it has as foremost purpose the circumvention of more burdensome regulatory requirements in the Member State where the economic activity is actually carried out. This is not allowed in the cases where the establishment in another Member State is designed improperly to avoid the national legislation of the state in which the business in fact operates or in the cases where abuse or fraud occurs. This makes a level of regulatory arbitrage for investors between the company and other laws regulating establishment in the EU Member States possible. Thus, in this sense it is not the same as the ‘Delaware Effect’ in US law, in which the favorable conditions of Delaware state company law promote a lot of US firms to incorporate there while doing business in other US states. There is no obvious equivalent of Delaware in the EU yet, even though the Luxembourg, UK and regarding tax treatment, the Netherlands have favorable regimes of company establishment.  

This legal development, by contrast, has a big impact on the internal laws of countries such as Austria and Germany, they identify a ‘seat’ theory of corporate personality and require the establishment of a company or branch in their jurisdiction if it carries out any business there. The new freedom to establish outside the jurisdiction of actual business operations brings along that such requirement will be contrary to the freedom of establishment. Derogation from the right to establish and the freedom to supply services is contained in Article 46 and based on public policy, public health and public security grounds. If there is no common Community policy regarding inward investment

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from outside the EC then Member States have discretionary power to form their policy for investors outside the EC. Not much disadvantage to investors should occur since EC Member States adopt an open door towards non-EC investors. Some restrictions are adopted in regulatory sectors that are sensitive.\textsuperscript{84}

\section*{§3.3 OECD}

Big capital-exporting states have adopted multilateral arrangements aiming to avoid barriers to inward investment. On 12 December, 1961 the OECD Codes on the Liberalization of Current Invisible Operations and on the Liberalization of Capital Movements were implemented. During the GATT negotiations in the Uruguay Round, big capital exporters focused on avoiding host states controlling entry and establishment of foreign investors. The consequence of this is the creation of obligations regarding investment dealing with intellectual property rights, establishment of services and performance requirements for entry of foreign investors. Unlike other OECD instruments that aim to protect investors (assets), the two OECD codes aim to liberalize transactions in the field of foreign investment. They seek to eliminate obstacles to investment and trade regarding capital movements and current invisibles. The codes are binding for all members as they have an OECD decision and have as goal to diminish national restrictions regarding transactions and transfers that fall under these two Codes. This includes an obligation to give the needed authorization to conclude or execute the transactions and transfers and a prohibition of discrimination in the use of liberalization measures regarding investors from other Member States. It is possible for members to put reservations in the case that directly full liberalizing is not possible.\textsuperscript{85}

Article 3 of each code allows a member to take action which it considers necessary for the sake of: "(i) the maintenance of public order or the protection of public health, morals and safety; (ii) the protection of essential security interests; (iii) the fulfillment of its obligation relating to international peace and security". Each member has the power to make sure the authenticity of transfers and transactions is valid and to take necessary measures to prevent avoidance of their laws or regulations. Not all measures in the code regarding liberalization have to be taken by members if the economic and financial situation of the member gives reason for that. When taken liberalizing measures lead to financial and economic problems members can derogate from them. This is also the case when there is a deteriorating balance-of-payment situation. Gradual liberalization of

\textsuperscript{84} P.T. Muchlinski, \textit{Multinational enterprises & the law}, the Oxford international law library 2007, p. 242-247.

\textsuperscript{85} P.T. Muchlinski, \textit{Multinational enterprises & the law}, the Oxford international law library 2007, p. 248.
restrictions is possible because of the derogation provisions in the case of reservations. This is possible when direct interests are in conflict with absolute liberalization.  

§3.4 NAFTA

If there is no significant multilateral treaty on FDI, Chapter 11 of the NAFTA between the United States, Canada, and Mexico can be seen as probably the most influential supranational body of investment law offering protection for FDI. Chapter 11 functions as an early warning signal in the context of expropriation of FDI. Chapter 11 is known as a reliable body of FDI law. Even investment tribunals that are not NAFTA tribunals or tribunals of its member states refer to Chapter 11. This Chapter 11 can also, with care, been seen as a classic BIT. Chapter 11 stresses the broad liberalization of FDI while BITs of recent date have sometimes evaded this.

The NAFTA illustrates a modern trade and investment agreement of early date. The power of any NAFTA member is limited to the conditions of the agreement when an investor from another NAFTA party is at stake. The members have common objectives, although they differ in their own viewpoint towards foreign investment. The United States had the expansion of investment as their purpose. The United States came with the idea to have a Minimum Standard of Treatment to foreign investment that should be the responsibility of states. Mexico subscribed to the Calvo principle, aiming equality regarding FDI. The United States, unlike Mexico, aimed full compensation for FDI expropriation. Public policy grounds are the reason for these differences regarding FDI. During the negotiations about Chapter 11 the parties were aiming to find a proper balance between regimes seeking liberalization of international investments and the ability of parties to selectively control FDI in the benefit of national interest. The known international standards, like the “National Treatment” and the “Most Favored Nation treatment” are intended to be used for NAFTA investors. This is to create a proper balance. Also for this reason substantive and procedural rules are created regarding the functioning of such standards to guarantee an equitable and consistent treatment of NAFTA investors.

The NAFTA is a trilateral free trade agreement between the US, Mexico and Canada focusing on the integration of their economies and entered into force on the first of January 1994. It has the

86 P.T. Muchlinski, Multinational enterprises & the law, the Oxford international law library 2007, p. 248-.
character of a framework that includes the foregoing agreements, to think of the bilateral free trade agreement between US and Canada with a detailed chapter about protection of investment. This has functioned as a model for provisions of the NAFTA. There were also agreements between the US and Mexico and between Canada and Mexico. Provisions regarding investment are in chapter 11 of part five. Section A contains principles of state action aiming to liberalize the North American investment environment and contains guarantees for investors. It offers the “North American Model” of liberalization of investment. National treatment and Most Favored Nation treatment are offered to investors of another party and their investments. These apply to the pre- and post entry phase, establishment and acquisition fall under the national treatment and Most Favored Nation treatment. National treatment is the standard that gives the better treatment to an investor will be applied. Most Favored Nation treatment means that the receiving party must receive equal to what the most favored nation would receive.

Under the NAFTA a non-discriminatory entry and establishment is ensured. In this context there is a “negative list” with exceptions, industrial sectors that are annexed to the agreement. Investors have the protection of minimum standards of treatment under international law. It is about non-discrimination regarding measures about losses as a consequence of civil strife or armed conflict, equitable and fair treatment and full protection and security. No performance requirements are allowed. The prohibition of the NAFTA goes further than the WTO TRIMs prohibition. It includes requirements to production processes, transfer of technology and other proprietary knowledge. Exception occurs in the case that a competition authority, court or tribunal imposes the requirement. It is possible, if this does not have a material effect on the investors ‘power to control his investment, to require that the majority of the board members have a specific nationality or resident at the territory of the requiring party. It is possible for parties to make reservations to the operation of national treatment and Most Favored Nation standards, and to the prohibitions on performance requirements and requirements for board membership, regarding any existing conflicting measures at the levels of federal, state, or local government. Thus a “standstill” on new restrictions is introduced.

For a public reason expropriation is allowed, although it must be non-discriminatory and in line with due process of law and international law. Compensation must be paid corresponding to the fair market value of the expropriated investment at the moment directly prior to the expropriation. Furthermore, Section A of Chapter 11 creates rights of action for administrative authorities regarding

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investment. It is possible for states to create measures for other contracting parties that are willing to establish an investment. But the protection that the agreement offers must not be harmed. It is also allowed to call for regular information from the investor about his investment. Also measures taking the environment in consideration are allowed as far as they are in line with the agreement. Parties state that the encouragement of investment must not be at the cost of environmental measures, health and safety. If this happens a party can demand a consultation.91

It is not allowed for states to impose national requirements on investors of other NAFTA member states that are not imposed on that state’s own nationals. It is only allowed to set transfer restrictions on investors if they are non-discriminatory, equitable, in line with the law and exercised in good faith. Chapter 11 of the NAFTA consists of four standards of treatment related to NAFTA investors: National Treatment, Most Favored Nation Treatment, Minimum Standards of Treatment and Standard of Treatment. Article 1105 contains a standard for “fair and equitable treatment” of investors, which is not the same as other treaty-based guarantees such as National and Most Favored Nation treatment. Chapter 11 also contains performance requirements on NAFTA parties, which prohibit NAFTA member states from

- tying sales to foreign exchange earnings
- persisting that investors buy local products and services
- demanding technology transfers other than corrective anticompetitive measures
- demanding foreign exchange inflows
- demanding technology transfers to, in particular, local companies
- requiring specific levels of goods or services
- requiring that foreign markets be supplied from local production.
- demanding a minimum of local content

Furthermore, the NAFTA requires that member states allow the uninterrupted and free transfer of investments at prevailing market rates of exchange.92

Section B of Chapter 11 deals with dispute settlement. It concerns disputes between a party and an investor from another party. Principles of due process, international reciprocity and an impartial tribunal apply in this context. Labor unions in the US were afraid of jobs shifted to Mexico as Mexico has lower rates and environmental principles. To avoid this President Clinton demanded extra agreements, as component of the NAFTA, for Mexico relating to labor rates and environmental

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91 P.T. Muchlinski, Multinational enterprises & the law, the Oxford international law library 2007, p. 239-242.
issues, as to decline the difference between US and Mexico in this. At the time of implementation of the NAFTA it was not clear if it will be good or not for the liberalization of investment. Chapter 11 includes primary instrument to use in an investment dispute under the NAFTA. Article 2022 in Chapter 20 contains the text promoting the use of international commercial arbitration in NAFTA related disputes in general. Chapter 11 straddles the separation of the liberalization of FDI under the NAFTA and the conditions under which host states may disallow such investment. Chapter 11 differs from most BITs as it has the possibility for investors of NAFTA members to choose between proceedings under the banner of this Chapter or to go for a domestic court. This choice must be taken with consideration of the problem in dispute, the conduct of host states, in combination with efficiency, cost, fairness and duration of proceeding. A different mode of arbitration can be chosen by investors when they are arbitrating under Chapter 11, different from public and traditional private arbitration. NAFTA members can still call down diplomatic measures against other states and use traditional arbitration. Thus Chapter 11 does not keep out other options.

There is a difference between dispute settlement through domestic courts and private arbitration and dispute settlement through Chapter 11. There is no body in the NAFTA that is supranational and responsible to consider human rights against other social concerns, like the European Court of Human Rights. Chapter 11 decisions are not directly integrated in the NAFTA member’s domestic law. This is different in European Union Law. No appeal is possible from a Chapter 11 decision, the parties in a dispute can review an award under this Chapter to a limited extent in international bodies or domestic courts of NAFTA members, like correction of mistakes. Differences in the standards of review give investors an incentive to forum shop between the domestic courts of NAFTA parties.

There is a lot of criticism about Chapter 11. One of the critics is that NAFTA parties bring Chapter 11 in to play simultaneously to encourage and undermine the liberalization of FDI. The critics are also including that the US government appeal to Chapter 11 unevenly. It promotes markets for its investors in countries of NAFTA partners and at the same time it is compelling regulatory measures protecting its own domestic markets against investors of those states of NAFTA partners. The US changed from encouraging and protecting liberalized FDI to using protective barriers against liberalized FDI. Think about the fact that US courts are now able to review Chapter 11 awards. The

93 P.T. Muchlinski, Multinational enterprises & the law, the Oxford international law library 2007, p. 239-242.
conflicting issues are more in the field of law regarding resolution of FDI. The GATT has a general exception clause that makes it possible for states to protect themselves from disputes investors will appeal regarding non-discriminatory regulatory measures. Chapter 11 does not have such general exception clause. NAFTA panels are told to distinguish between discriminatory and non-discriminatory measures.96

In Loewen v. United States and Methanex v. United States the U.S. courts interpreted the regulatory practices of the US expansively to legitimate discriminatory practices. A motivation for Chapter 11 was to create a balance between investor rights, labor, domestic economic interests and environmental interests. A fear is that NAFTA states may surrender to foreign investor pressure, or labor, environmental and local investor interests. There is fear that, instead of evaluating the legitimacy of investor rights, NAFTA members tend to regulate FDI for political reasons. A reason to have Chapter 11 for dispute resolution was the attempt to avoid having courts in the domestic area that do not have expertise in the field of FDI. A risk is the development of a Chapter 11 jurisprudence that is improperly responsive to investor expectations at the expense of the material interests of domestic states. There is a fear that Chapter 11 tribunals may be short of FDI expertise. There is a risk that they can be excessively responsive, or on the other hand, insufficiently responsive to state interests.97

The NAFTA can be seen as a tool for the creation of a single market and can present a model that focuses on the cooperation between developed and developing countries. It can also be argued that the NAFTA is a kind of protection, as a preferential treatment for the parties and an exclusion of the rest. If NAFTA is successful in encouraging liberalization of investment, then others that are not members of the NAFTA can profit from it by being present in a NAFTA member state.98 Chapter 11 is open textured and it is flexible to interpret. Also important is that the NAFTA some parties are hesitant towards Chapter 11 and towards uniform methods of addressing its perceived limitations. It is shown throughout the years that issues regarding international investment do not change quickly. State sovereignty and economic self-interest are factors that play a role in making a multilateral

98 P.T. Muchlinski, Multinational enterprises & the law, the Oxford international law library 2007, p. 239-242.
agreement on FDI difficult. Also the dissension amongst countries makes it difficult. Dissimilar policies relating to FDI as exercise of sovereign power cannot lead to uniformity.99

§3.5 WTO and GATT

The WTO is an organization for trade opening. It is the place for states to negotiate trade agreements and to settle trade disputes. It uses a system of trade rules and it looks for solutions for trade problems.100 The GATT is part of the aim to create multilateral institutions after the Second World War that encourages harmonious relations among nations. Quotas are not allowed by the GATT and tariffs must be negotiated, bound and applied on a nondiscriminatory basis. In the context of trade liberalizing rounds tariffs can be decreased. WTO members must not use domestic instruments to protect their domestic production. The only protection that they can achieve is protection through their tariffs.101

§3.5.1 WTO

WTO liberalizes investment and trade, however it has been hesitant to liberalize international investment like the liberalized trade. Reluctance to liberalize FDI by developing states was clear to the United Nations. In 1962 the General Assembly Resolution 1803 was passed by the United Nations that emphasized “permanent sovereignty of states over natural resources and sanctioned ‘nationalization, expropriation or requisitioning’” on “grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests”. Protection of natural resources became dominant national public policy. Hereafter, other sources entrench state sovereignty over foreign investors. As mentioned before, there was a reluctance to liberalize international investment, but important issues to note are the fact that individual WTO members liberalize FDI and the fact that the WTO selectively liberalize FDI.102

There was reluctance towards liberalization of FDI, but still the WTO pronounced limited agreements on investment. A makeable agreement was the Agreement on Trade-Related Investment Measures (TRIMs Agreement) but the scope of this agreement was held limited. Trade in goods has been held apart from FDI and particular trade distorting performance requirements regarding foreign

100 <www.wto.org/english/thewto_e/whatis_e/who_we_are_e.htm>.
investment are prohibited without harmonizing regulation on foreign investment. No attention was paid to some particular regulatory measures like personnel entry restrictions, technology transfers and licensing requirements. Other international agreements that are important in the case of investment are the GATS, the TRIPS and the Agreement on Subsidies and Countervailing Measures. GATS focuses on trade-related services, TRIPS contains duties on states to protect intellectual property rights and the Agreement on Subsidies and Countervailing Measures regulated government granted benefits and included actionable remedies and selected prohibitions.\textsuperscript{103}

Developing states that were not willing to liberalize international investment throughout the WTO and the United Nations sometimes created partnerships for investment and trade on a selective basis. Countries in the east of Europe which were reluctant towards FDI before the Cold War began to support their economies through bilateral investment agreements (BITs) and free trade agreements (FTAs). China was resistant regarding FDI but nowadays China has an affirmation of FDI, even though it is stringent regulated on the basis of national interest grounds. This brought problems as there were individual interests for the closing of BITs and the common interest of developing countries was not focusing on liberalizing FDI. Developing states that voted against FDI conclude several investment agreements, while having a need of loyalty to WTO agreements. These countries took calculated risks. Frequently costly social and economic infrastructures were created which states could poorly manage to have. This was created with the goal to show potential investment partners that they are economically sustainable. Those states sometimes kept political dissent and distributed the benefits of FDI inequitably for the sake of powerful local interests, political stability, and attraction of FDI. This was not limited to developing countries only.\textsuperscript{104}

Developed states were pro liberalization of FDI but in time they began to feel pressure that came from domestic interests to regulate FDI. This became more and more since the investment inflows became more than the outflows. Also domestic investors lost their competitive benefit. This sometimes led to a negative effect on the balance between regulated and liberalized FDI. Occasionally, developed states gave implied support to abuses by developing countries on a regulatory basis. They did this to get attractive footholds for their investors in those developing countries. The unequal distribution of resources was emphasized hereby.\textsuperscript{105}

The group of foreign investors became broader and regulation of varied FDI practices became complex. Modifications of FDI hamper the development of FDI. FDI was once limited to the direct investments of multinational corporations, then FDI spread out to contain a group of foreign investors and investments not restricted to those of affiliates, subsidiaries, and other strategic partners of multinational corporations.\textsuperscript{106}

§3.5.2 GATT

After the Second World War a new period of investment and trade liberalization began. General Agreement on Tariffs and Trade (GATT) was created in 1947, with the reason to lessen protectionist barriers that can be an obstacle to investment and trade. The goal was liberalization. The GATT did not apply on FDI in principle, but in 1955 a resolution on International Investment for Economic Development was adopted carrying out the advice for members to close bilateral investment agreements. The GATT Panel in \textit{Canada–Administration of the Foreign Investment Review Act} was about the question if Canada engaged in “trade distorting” measures and violated the GATT knowing that is has the right to regulate foreign investment. In this respect the panel did recognize the limited extent of the GATT in regulating FDI.\textsuperscript{107}

There has been expansion of several forms of international rules regarding foreign investment in the last decade. Of importance are bilateral investment treaties (BITs), sectoral investment Treaties (the Energy Charter Treaty) and regional investment Treaties (such as Chapter 11 of NAFTA). States that were involved in the decolonization after the Second World War wanted political and economic independence. Foreign investment became a substitute for colonialism with expropriation of foreign owned property in the 1960 and 1970s to a great extent in the developing world. This had a huge effect on the normative development of international economic law regarding foreign investment. For developed states protection of investment in a way of guarantees of compensation against expropriation obtained throughout BITs became the important purpose, instead of the liberalization of restrictions on investment. A reason for this is the worry that customary international law is developing in a way that is not in line with the interests of foreign investors and their home states. Strong guarantees on protection of investment in the majority of post-war BITs functioned in harsh contrast to the early routes in international trade law. The

normative principle pervading the generation of the GATT has been described as “embedded liberalism” where the economic order is a function of the social. This is mostly clear in Article XX which allows deviation from GATT disciplines for the purpose of a list of regulatory objectives counting health and environmental measures as well.  

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The constructers of the GATT framer are aware of the sensitivity of a balance between maintaining important parts of regulatory autonomy and the liberalization of discriminatory trade barriers. The BIT programs post war differs from this. The most BITs have strong unqualified guarantees of investment protection with no regulatory “out” like Article XX GATT.  

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§3.6 FCN treaties

FCN treaties progressed the liberalization of FDI. They were used as a protection of own investors who were active in foreign markets falling under the area of the GATT and were used for dispute resolution as they offered it. FCN treaties have a small extent of influence and lack the reaching of an agreement on a multilateral investment treaty.  

110 FCN treaties overlap partially with the early development of modern BITs and FTAs. In 1959 West Germany and Pakistan made an investment agreement. This was the beginning. Afterwards, BITs increased and became a substitute for a global agreement on FDI, which the WTO and United Nations were unwilling to carry out.  

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BITs and FTAs differ from each other. Their parties have uneven economic clout, they define “investor,” “investment,” “asset,” and “enterprise” in a different variable way and they have different standards of treatment regarding foreign “investors” and “investments”. They also differ in their way of resolving international investment disputes. The first BITs were more between developed Western states balancing partially the collective economic and political will of developing states over the investment system and multilateral trade. The BITs of nowadays include both, developed and developing states. BITs consist of provisions regarding national or most-favored nation treatment to foreign investment, assuring reasonable exchange rates for transfer of funds for investment, control expropriation of investments and pursue the payment of adequate

compensation. BITs also consist of performance requirements for host states to impose on foreign investors. In case of an investor-state dispute the BITs offers investment arbitration or the resolving of the dispute in domestic courts of host states.\textsuperscript{112}

States differ in their choice between BITs and FTAs, they focus on their strategic interests. The US adopted an important FTA, the NAFTA. It pursued to build a free market through the FTAs for the US trade and investment abroad. BITs were concluded by the US in 1998 only for its global strategy. The most articulated BITs and FTAs provisions were about expropriation. They contain the requirement for signatory parties to agree not to expropriate FDI as far as the implemented measures are nondiscriminatory, offer host investors with due process of law, parties apply them for public aims and they make payment of fair, timely and adequate compensation in consequence of a legitimate “taking”.\textsuperscript{113}

FDI is being regulated in a different manner by BITs and FTAs, as they differ in the standards of compliance they impose on investors for example. Furthermore, they differ as they have uneven guidance on the permissible nature and limits of a “government taking”. BITs and FTAs resolve investor-state disputes with different mechanisms and formulas. BITs and FTAs that concern the resolving of investor-state disputes by investment tribunals depend on varying degrees on the ICSID, ICSID Additional Facility, or UNCITRAL Rules. These deviate from customary international law by which states (not private investors) are parties to international investment disputes. These also produced increasing \textit{ad hoc} jurisprudence on investment law which added to the international \textit{opinio juris} on investment law, although it has not the binding force of common law precedent.\textsuperscript{114}

Sometimes BITs are ordered by the dominant party. Developed states present them to developing states and are concluded without extensive bargaining over the terms. BITs have a great effect on the regulation of investment disputes. It also shows the imbalance in the economic and political power of the members. To think of the growth of sovereignty encouraging aspects in recent BITs. Because of the absence of harmonization in the nature and treatment of BITs and FTAs uncertainty may occur as to how courts and investment tribunals might apply them.\textsuperscript{115}

There can be confusion due to dissimilarities in dispute resolution mechanisms in BITs and FTAs and due to the way investment tribunals interpret them in practice. States can also face the fact that they do not get what they want from a concluded BIT, as it is possible that a certain BIT or FTA offers partner states and investors more strategic advantage than it does to them and their investors. The chosen strategies for negotiating and applying Bits and FTAs can result in an opposite effect. These are risks that occur when conclude investment agreements. It is also about choices make depending on the perceived economic, political and social benefit at the time, but then turn out to be incorrect. Furthermore, there is a concern that BITs may corrose the authority of multilateral institutions like the WTO. There is less reason to conclude a multilateral accord regarding FDI because of the existence of BITs and FTAs and their growth and influence. Well, it is less complicated to reach a bilateral or regional accord instead of concluding a global consensus under the WTO (think about the failure of the OECD which abandoned the draft agreement because of opposition from its members, although it had uniform standards and principles regarding FDI).116

To have uniform standards for the liberalization of FDI discrepancy in political, cultural, and economic must decline. Through FTAs and BITs countries close discrete investment agreements with selected regional, local, and global partners. This will withhold systematic legal reform of FDI. There will be confusion in the regulation of FDI and the uniform treatment of FDI will be disturbed due to FTAs and BITs that agree to diverse principles, standards and protocols. This brings a risk of conflicting FDI laws and disturbance of FDI initiative.117 The importance of FTAs and BITs must even though stay in place. There is a call for an integral body of investment law that combines investment practices and investment rules that are not captured to state powers but nevertheless are responding to the use of state power. Interests of host states are important and must not be forgotten when protecting foreign investors. There is a need for an effective agenda so states, investment tribunals and courts can reorganize international investment standards and protocols. More consistency in international investment law can be achieved although there are differences in decisions regarding investment cases. Dissimilarity is inevitable because investment occurs at different abstraction levels and legal models regarding property rights are different in each legal

regime. It is hard to create an international investment regime, identified by the international society and the states that are involved in creating this regime.118

§3.7 Conclusion

I have discussed a lot of international laws and regulations in this chapter. Some state that investment treaties differ and that treaties that protect more will bring more investment flows. The effect of Treaties on FDI is a volume of significant intellectual value that represents the definitive treatment of this most controversial issue within international investment law.119 FCN treaties give each contracting party the guarantee that investors have the freedom of entry and establishment. The BITs of US and Canada assure non-discrimination in the pre and post-entry stage, including the right to found an investment. The European Internal Market of the European Community has a single common market as goal, which will be ruled by harmonized supranational regulations. The NAFTA contains provisions you normally do not find in a simple free trade agreement. The NAFTA can be seen as a ‘halfway house to a North American common market’. Furthermore, individual WTO members liberalize selectively FDI. The NAFTA focuses on ensuring free access for investment and trade while the participating states keep the national power of economic regulation.120

120 P.T. Muchlinski, Multinational enterprises & the law, the Oxford international law library 2007, p. 238-239.
Chapter 4: Conclusion

The aim of my thesis is to find an answer to the following question:

*What is the role of law in foreign direct investment and how to create a legal framework that will have a positive effect on foreign direct investment?*

There must be a balance between the costs and benefits of law obstacles regarding foreign direct investment. Obstacles are not only and always bad, they can serve a national interest. Well, in my opinion, there will always be some specific national interests that must be protected. These interests are of public importance and should stay untouched. When regulating FDI one must be aware that states will not deviate from their protection of national interests and this should be no problem. There must be a balance regarding fair FDI and protection of national interests. Thus, trying not to hurt the rights of investors and saving the national interests of states. It is not allowed, in my opinion, to interpret national interests extensive, only very important public interests can fall under this (national security for example). The national interests must be proportionate, a balancing exercise must be made in this respect. Both states and investors have the right, in my opinion, to protect their rights. As each party (state and investor) will pursue the own interests, it is of importance that the law finds a balance between the interests and safeguards the benefits of FDI. States must apply regulatory practices equally. States that attract FDI with their laws and regulations must not create nationalization and expropriation. The national and international policy environment, including law and the legal system, has an effect on the direction and flow of FDI. In this respect it is important to notice that it is not possible to have a “one-size-fits-all” FDI policy, as every state/situation can differ. There must be uniformity but still some differences will exist as an adjustment to states and situations. To have uniform standards for the liberalization of FDI discrepancy in political, cultural, and economic must decline, as much as possible.

There is a difference in opinion regarding the effect of FDI on economic growth.\(^{121}\) FDI will encourage economic growth but this depends on the state at stake, the nature and use of FDI and last but not least the regulation regarding FDI.\(^{122}\) States must be capable to benefit from FDI flows, to accomplish this they have to possess certain qualities.\(^{123}\) A competitive and free market is more

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beneficial to the economy. There is an assumption that less regulation will stimulate economic growth. Thus, rules on FDI must not be excessive.

The economically advanced states as well as the less developed states had more and more relaxed their strict investment control and foreign ownership regulation. They also putted less strict conditions on the investments and investment screening laws are applied less restrictive. The outright prohibition of foreign investment policy by socialist states is almost outdated. Industrial sectors reserved for public ownership are less nowadays and this brings more opportunities to invest. Many states pursue privatization as to increase the overall level of inward foreign investment in the economy. The prohibitions on foreign investment that still exist are to be found in sectors of the national economy important to national security. Thus, one can see that there is a positive development towards more liberalization. States are nowadays aware of the fact that they must decrease their restrictions. This positive attitude in combination with uniform effective rules and regulations will lead to a beneficial environment for FDI. One can say that positive steps are now taken and that these steps can be completed by an effective legal framework.

The conflict between liberalization of investment and state sovereignty must be resolved by international law. More consistency in international investment law can be achieved although there are differences in decisions regarding investment cases. Dissimilarity is inevitable because investment occurs at different abstraction levels and legal models regarding property rights are different in each legal regime. It is hard to create a uniform international investment regime, identified by the international society but it is worth trying and achievable. The internal strategy regarding FDI and the position in the international competition for FDI of states are influenced by the sensitivity of investors. An effective legal system will attract investors who are sensitive to legal systems, thereby states with such an effective system will have an absolute advantage. There is an expansion of several forms of international rules and regulations regarding FDI in the last decades. Of importance are BITs, sectoral investment treaties and regional investment treaties.

It must be prevented that wealthy (corporate investors of) developed states rule global investment markets, with a FDI regulation in their benefit. Developing states must have an influence on the FDI terms and conditions. Through FTAs and BITs countries close discrete investment

agreements with selected regional, local, and global partners. Although BITs and FTAs bring advantages, they can withhold systematic legal reform of FDI. There will be confusion in the regulation of FDI and the uniform treatment of FDI will be disturbed due to FTAs and BITs that agree to diverse principles, standards and protocols. This brings a risk of conflicting FDI laws and disturbance of FDI initiative.\(^\text{127}\) The importance of FTAs and BITs must even though stay in place.

The NAFTA can be seen as a tool for the creation of a single market and can present a model that focuses on the cooperation between developed and developing countries. It can also be argued that the NAFTA is a kind of protection, as a preferential treatment for the parties and an exclusion of the rest. If NAFTA is successful in encouraging liberalization of investment, then others that are not members of the NAFTA can profit from it by being present in a NAFTA member state.\(^\text{128}\) Chapter 11 of the NAFTA is open textured and it is flexible to interpret. Also important is that some NAFTA parties are hesitant towards Chapter 11 and towards uniform methods of addressing its perceived limitations. It is shown through the years that the issues around international investment do not change so quickly. State sovereignty and economic self-interest are factors that play a role in making a multilateral accord on FDI difficult. Also the dissension amongst countries makes it difficult. Dissimilar policies relating to FDI as exercise of sovereign power cannot lead to uniformity.\(^\text{129}\) Well, I see the NAFTA as a good example, despite the negative aspects I mentioned here. The NAFTA brings uniformity. If it works on the above mentioned critical aspects, it can be used as a good example.

Also the EC treaty is good for FDI as it brings more freedom for investors. Furthermore, FCN treaties give each contracting party the guarantee that investors have the freedom of entry and establishment. Individual WTO members liberalize FDI and the WTO selectively liberalizes FDI.\(^\text{130}\) All these rules and initiatives are positive. Even though, there is a worry that customary international law is developing in a way that is not in line with the interests of foreign investors and their home states. When setting rules on FDI there must be a focus on the general interests of foreign investors and their home states. When setting the rules one must try as much as possible not to harm interests of foreign investors and their home state. Thus, also here a balancing exercise is needed. I also would like to notice that when I did my research and wrote about several laws and regulations I noticed that a lot of rules are formulated more general (think of the opentextured Chapter 11 of the NAFTA).


To achieve uniformity more concrete rules must exist. This would be a clear guidance for investors and states.

International investment tribunals put afford to improve unequally considered and fractured applied international jurisprudence. It helped creating an investment law body that intermediate between rights of investors and difficult interests of states. It is not possible to expect that they come with a coherent and sustainable regime for regulating FDI when there is no supportable institutional fabric. This so called fabric is in hand of the states that must know that liberalization of FDI does not only benefit foreign investors but also benefit them too. States must be aware of the fact that the multilateral end product is probably bigger than the sum of the different state parts.\textsuperscript{131}

To reach that the multilateral community is better informed about the mechanisms and means regarding the regulation of FDI an international investment secretariat is needed. This secretariat can encourage states to engage in the formulation and application of international investment law. The secretariat can be allowed to define inconsistencies, complexities and delays in resolving FDI investor-state disputes and to offer logistical support dealing with these matters of difference to prevent conflicts. It also could work together with investment bodies founded under existing conventions such as the ICSID, the WTO and regional treaties like the European Union and NAFTA in the reform of international investment law.\textsuperscript{132}

In this chapter I presented the answer to my question. As I have emphasized in my thesis the role of law in FDI is of great importance. It is the tool to use to achieve more liberalization and uniformity in the world of FDI. In this chapter I highlighted the important aspects to take into consideration when setting al legal framework for FDI. With the (international) laws and regulations we have at the moment we can say that we are heading in the correct direction. Important is to balance the interests of states and investors, they both have to sacrifice some of their interests to achieve a better framework for FDI. Parties must come together to discuss and find a balance. This way the legal framework will have public support and thus a beneficial effect on FDI. A uniform legal framework will achieve uniformity and thus better guidance for investors and states in dealing with FDI. A concrete and clear legal framework is needed to encourage beneficial FDI. The laws and regulations that exist at the moment are a good development. Improvement of these rules and


regulations focusing on the critics that I have mentioned above will bring a positive effect to the world of FDI.
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