REPORT
QUITO FTAA MINISTERIAL
WORKSHOP ON INVESTMENT[1]

This report presents the discussion that took place during a civil-society workshop on investment at the *Forum Towards Civil Society Participation in the Americas* in Quito, Ecuador, 29-30 October 2002, on occasion of the VII Ministerial Conference of the FTAA. The structure of the report does not follow the chronological presentation of arguments, but regroups them in three themes: 1) an introduction to trends in the Americas; 2) analysis of the relationship between foreign direct investment (FDI) and sustainable development; and 3) observations on how home-state obligations and corporate social responsibility may help to overcome the shortcomings in the dominant paradigm of investment de-regulation.

I. FDI: Trends in the Americas

1. FDI Inflows[2]

In the 1990s, inflows of foreign direct investment (FDI) into Latin America and the Caribbean grew rapidly. In 1990, FDI accounted for about 5 percent of the region's total investment (gross fixed capital formation). By 1999, that share had risen to 27 percent, falling to around 20 percent when FDI inflows dropped off after 1999.

FDI inflows into Latin America and the Caribbean were $85 billion in 2001, accounting for about 11 percent of global FDI inflows. About 40 percent ($36 billion) went into mergers and acquisition by foreign investors of existing companies, including via privatization. The rest was in "greenfields" investment, that is, the creation of new productive capacity.

The distribution of FDI within the region is highly skewed, with the lion's share going to Mexico and Brazil and—before the financial and economic crisis—Argentina, as well as Bermuda and the Cayman Islands. In 2001, Mexico and Brazil alone received about 46 percent of the region's FDI.

Growing steadily in the 1990s, annual FDI inflows peaked in 1999 and then fell sharply by 24 percent by 2001. The most severe drop-off was in Argentina: FDI inflows fell from $11 billion in 2000 to just over $3 billion in 2001.

However, in some countries, notably Mexico and Chile, FDI increased after 1999. In Mexico, FDI inflows nearly doubled in 2001, rising to $25 billion and catapulting Mexico over Brazil as the region's largest FDI recipient. The implication for a longer-term trend, however, is unclear, since a single transaction—the acquisition of Banamex by Citigroup—accounted for nearly all the growth. In Chile, FDI grew by 50 percent in 2001, rising to $5.5 billion.

Transnational corporations (TNCs) from the United States and Canada are major investors in Latin America. In 2001, the US was the source of about a third of all FDI inflows into the region. In the 1990s, however, FDI from Spain rose dramatically as Spanish investors chose Latin America for international expansion strategies and massively acquired private companies in the services sector. In

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[2] Data for this section are from UNCTAD, *World Investment Report*, 2002 and 2002.

Brazil, Argentina, Chile and Mexico, for example, Spanish FDI soared to nearly $30 billion in 1999, dropping off dramatically to around $3 billion by 2001.

By sector, the share of FDI in services increased significantly in the 1990s, while falling in the manufacturing sector. In 1999, services accounted for 52 percent of total FDI, up from about 25 percent a decade before. In the primary sector, however, the share of FDI rose slightly over the 1990s, from 9.6 in 1988 to 12 percent in 1999.

The sectoral distribution of FDI differs in different parts of the region. In the Andean countries, FDI flows mostly into natural resource-intensive industries. In Mexico and the Caribbean Basin countries, manufacturing has been an important sector for FDI, especially the *maquila* enterprises exporting to the United States. However, FDI in manufacturing in Mexico fell in 2001, largely as a result of recession in the US, and rose sharply in the financial services sector. Brazil, on the other hand, saw a rise in FDI in manufacturing, which now accounts for about a third of FDI.

In general, FDI has played a different structural and developmental role in the economies of the southern versus the northern part of the region. In South America, FDI has tended to concentrate in non-tradable services, manufacturing for local markets, and resource-intensive industries. In Mexico and the Caribbean Basin countries, investment by TNCs has concentrated on building production and export platforms for the North American market, especially in automobile, textile, and electronics industries.

2. The Emerging Paradigm: Investment Disciplines in the Americas

The highly bracketed language in the investment chapter of the FTAA negotiating draft reflects the lack of regional consensus regarding the content of investment disciplines. At the same time, the fact that there is a chapter on investment indicates widespread acceptance of the role of the FTAA in developing investment disciplines. Despite the differing options in brackets, current trends in the Americas and beyond shed light on the emerging regional paradigm for investment liberalization. The emerging paradigm may be gleaned by examining the general architecture of the NAFTA, as well as Bilateral Investment Treaties (BITs).

NAFTA devotes a whole chapter to investment disciplines, which are aimed at creating a predictable framework for the protection of investor rights. According to the substantive rules included in Chapter XI, the host state acquires certain obligations in regard to the treatment of foreign investors in its territory. The rules provide disciplines on expropriation, the applicability of international minimum standards, the prohibition of performance requirements, and national treatment (NT) and most-favored nation treatment (MFN). These substantive rules establish the basic legal framework for the treatment due to the foreign investor by host states.

Chapter XI of NAFTA also establishes that disputes between an investor and a host state shall be settled through binding international arbitration. That is, an investor who feels that the rules have been breached has the right to request that the dispute be submitted to an international arbitral tribunal. In such a case, the investor will be required to waive its right to initiate or continue litigation in the domestic courts of the state, except for non-monetary remedies. In constituting the arbitral tribunal, the investor is entitled to appoint one arbitrator, the host state another, and the third by agreement between the parties. The arbitration will take place under the World Bank's International Center for the Settlement of Investment Disputes (ICSID), ICSID Additional Facility, or United Nations Commission on International Trade Law (UNCITRAL) rules, and will normally conclude with an award either dismissing the application or awarding monetary damages to the investor. Finally, each party shall bear its own legal and other costs, except where the tribunal decides otherwise.

BITS have followed the earlier treaties on friendship, navigation, and commerce in granting protection to foreign investors. During the 1970s and 80s, the popularity of BITs was on the increase, reaching an explosion during the 1990s; currently, there are more than 2100 BITs worldwide. As BITs are bilateral, power imbalances between the two parties may be further accentuated in these agreements. At the same time, their bilateral nature means that each agreement may be different.

The bilateral nature of these agreements makes it difficult to identify common features to all agreements. For example, some agreements contain capital control formulas in cases of economic crises, the screening of investments by local committees, and requirements for the exhaustion of local remedies before international arbitration. Other common features include the standard of treatment, repatriation of profits, and disciplines on expropriation. The most recent BITs also include provisions on transparency, *i.e.* access to documents and open hearings of arbitrations, as well as on public participation through *amicus curiae* briefs.

The investment disciplines landscape would not be complete without reference to the important debate over the evolution of customary law on diplomatic protection. In the Americas, the conflict between the United States and Latin American countries regarding the treatment to be accorded to foreign investors has extended for over a century. The divergence of views extends to issues such as the abuse of diplomatic protection, interference in domestic affairs, and the relevance of international standards. The *Calvo* doctrine emerged as the expression of the resistance of Latin American states to the abuse of diplomatic protection, with implications in three spheres: national treatment, diplomatic protection, and the exhaustion of local remedies.

In the *North American Dredging Company* case in the 1920s, the United States-Mexican Claims Commission authoritatively expounded the nature and scope of the *Calvo* Clause, requiring the exhaustion of domestic remedies before jurisdiction at the international level. The insistence on subjecting foreign investment solely to the domestic law of the host state has been repeatedly reiterated by Latin American countries in Pan-American conferences. It has also been introduced into the Constitution of many countries

During recent decades, however, the positions in this debate have changed considerably. Mexico, a long-time proponent of the *Calvo* doctrine, has accepted Chapter XI of the NAFTA. Many other countries in Latin America have entered into BITs containing disciplines and language that significantly depart from the *Calvo* doctrine. (See table ##) Against this background, fears about abuses in diplomatic protection have been over-ridden by the recognition by several countries in the Americas that foreign investment may play an important role in the development process. The debate has thus expanded to the kind of rules necessary to ensure that FDI contributes, rather than undermines, the transition towards sustainable development.

II. FDI and Sustainable Development

The role of FDI in promoting—or undermining--sustainable development is at the heart of NGO concern about the investment provisions of the FTAA. Operating without global and often inadequate local regulatory oversight, TNCs have been the target of criticism for inflicting "direct harms"—pollution and natural resource degradation, toleration of worker abuse by subcontractors, inadequate protection of worker health and safety, and complicity in the violation of human rights. Moreover, there is also the risk that FDI will thwart, rather than propel, the economic development process itself.

NGO concerns about FDI thus fall broadly into three categories: 1) the economic impacts of FDI in terms of development, growth and equity; 2) the potential for FDI to cause or accelerate environmental degradation and resource depletion; and 3) the impacts of FDI on labor and human rights. The Workshop focused primarily on the first two.

1. Does FDI Promote Economic Development?

Given the right institutional and policy framework, FDI can potentially bring two broad kinds of economic benefits to developing countries and communities. First, FDI can help to stimulate economic growth, including via increases in income, employment, and foreign exchange. With good policies, these benefits can help to reduce poverty and narrow gaps between rich and poor.

Second, FDI can potentially help to nurture long-term increases in local productive capacities. Foreign companies can help to transfer technology and good management practice, help to increase the productivity of domestic firms, and stimulate domestic investment. Moreover, large TNCs can generate spillovers by stimulating local suppliers and integrating local firms into global production networks.

The capture of these benefits, however, is far from assured or automatic. Risks stem from the possibility that FDI will lower, rather than raise, domestic savings and investment, including via profit repatriation; "crowd out" domestic companies from capital markets; increase demands for foreign exchange; support local oligopolies and be anti-competitive; distort local politics and thwart regulation; and create instability through increasing financial volatility. Moreover, TNCs may seek to protect technology rents rather than transfer technology, reducing or eliminating hoped-for spillovers and externalities.

What is the more likely "face" of FDI? A host of studies over the past decade have examined the nature of economic benefits and the conditions under which they are—or are not—captured. Despite the prevailing wisdom that FDI benefits development, recent studies have found cases where FDI had a clearly *negative* impact on the economic welfare of the host country–that is, that FDI did not promote development. Moreover, several firm-level studies have found that FDI did not accelerate economic growth or promote positive spillovers from foreign to domestic firms.

Many studies find that the economic impacts of FDI in developing countries may be positive *or* negative, depending on a variety of variables, mostly having to do with host country institutions and policies (Table 1). In a recent report, the OECD concluded that the overall benefits, while "well-documented", depend on "the appropriate host-country policies and a basic level of development".

What the "right policies" are, however, is a matter of contention, as well as investigation. While it is slowly changing, the dominant paradigm—despite new scholarship to the contrary-assumes that uniform economic growth will follow from policies which promote global integration, protect foreign investors, and minimize government intervention.

Table One

Does FDI Promote Economic Growth?

Study Author(s)	Year	Yes, No, Maybe	Key Variables
Carkovic & Levine	2002	*No*	Doesn't generate spillovers
Lensink & Morrissey	2001	Yes	Reduces costs of R&D and promotes innovation
Loungani & Razin	2001	Yes but…	Risks

Hanson	2001	No	Doesn't generate spillovers
Willem te Velde	2001	Maybe	Depends on industrial & macroeconomic policies
Lim	2001	Maybe	Depends on tax incentives, regulatory & legal impediments, macroeconomic instability
Marino	2000	Yes if…	Open trade and investment policies
Aitken & Harrison	1999	No	Reduces productivity of domestic firms; doesn't generate spillovers
Mallampally & Sauvant	1999	Maybe	Human resource development; information and other infrastructure
Markussen & Venables	1999	Yes	Raises productivity and exports of domestic firms; generates spillovers
Moran	1998	Maybe	Depends on policy variables controlled by host authorities
Borensztein et al	1998	Maybe	Depends on education level of workforce
de Melo	1999	Maybe	Depends on open-economy performance and domestic policy
Blomstrom & Kokko	1996	Maybe	Impacts depend on industry and host country policies
Graham	1995	Yes but …	MNC's market power can generate negative impacts

This policy basket, however, may have little to do either with attracting FDI or utilizing it wisely to promote sustainable development. For example, studies have found that export performance requirements are very effective in promoting technology transfer. And there is little evidence that bilateral investment agreements have had much impact on attracting more FDI.

If rigid, free market norms become institutionalized in investment agreements at the WTO and FTAA, flexibility and national "policy space" for development, including sustainable development, will be lost.

2. FDI and the National Institutional Context

Foreign investment, by itself, is no guarantee of economic growth and even less of sustainable development. Furthermore, economic openness by itself is no guarantee of increased investment flows. Other ingredients are necessary to capture the potential positive effects of foreign investment. These ingredients extend beyond the scope of a commercial international agreement and pertain to a national strategy for development.

In general, investment is an important and necessary ingredient of economic development. The potential benefits of foreign investment include technology transfer, increased local innovation, and strengthened comparative advantage. However, foreign investment can be counterproductive in some cases, and does not necessarily complement internal savings when a country's conditions are not favorable. These conditions have to do with, *inter alia*, institutional aspects, labor skills, and infrastructure. Moreover, in order to reap the potential benefits of foreign investment, including local actors—government, business, civil society—need to take a pro-active role in developing national or sectoral development strategies and strategic alliances with foreign investors. These strategies would be aimed towards helping local economic actors to develop special capacities, niches, and dynamic competitiveness in certain fields.

What type of investment could go to a country without a highly skilled work force, poor physical infrastructure, and weak or non-existent institutions? What we can expect is foreign investment in *maquiladoras* or textiles seeking cheap unskilled labor. This kind of investment has shallow roots and is vulnerable to changes in wages, both domestic and foreign: if local wages rise, foreign companies can relocate in cheaper wage countries. In contrast, in a country with skilled manual labor, good infrastructure, a moderate institutional development and social stability, it is probable that foreign investment will target higher value added activities and sectors with greater linkages to local business.

The economic benefits of foreign investment, in short, are not automatic but depend on local conditions. In addition, it is not possible to assert that investment will promote a better local distribution of wealth or income. Again, if in the country recipient of investment there are no policies or legislation aimed at obtaining a more fair distribution, the effect of investment will be a higher concentration of wealth.

Foreign investment can also be prejudicial to sustainable development if local environmental institutions do not function properly, or if existing conditions promote the negative aspects of investment, *i.e*., corruption, crowding-out, etc. To be clear, if foreign investment, as well as the market in general, lack clear disciplines, it does not contribute to sustainable development. That is to say, investment and capital in general seek higher profits and lower costs. In the era of the industrial revolution, the working day was 14 to 18 hours and required women and children to work in terrible conditions. In time, basic rights and institutions were developed which limited "market forces" and provided social protections.

The same situation occurs nowadays with respect to the environment. Left to their own devices, foreign investment and the market do not take into account the environmental externalities they impose on others and internalize their environmental costs. But little by little investors and the market as well come to realize that these environmental costs must be accounted for if the economic system is to last at least another 200 years. Therefore, the emphasis must be to set national, as well as regional, frameworks to govern investment so that it can it does not threaten the environment and sustainable development in general.

3. FDI and the Environment

The impacts of FDI on the environment can be traced through three routes:[i]

- *Environmental performance* of TNCs;
- *Impacts of economic growth, including on local production and consumption patterns;*
- *Impacts on national and global environmental regulation.*

(a) Performance of TNCs

Two key strategic and management decisions of TNCs affect their environmental performance. First is the choice of technology, *viz*, whether to invest in newer, cleaner "best available" or to "dump" older, dirtier technologies. In most industries, a range of technologies are in use. Efficiency and "clean-ness" may be a function as much of industry sector as of company choice: some industries are more technologically dynamic than others.

The second decision has to do with management practice, *viz*, whether the corporate parent has embraced high standards and demands them from its overseas subsidiaries and supply chains. NGO advocacy campaigns have increasingly and effectively prodded companies into compliance with existing environmental regulation, and to adopt "voluntary initiatives" to go "beyond compliance" in

global operations. Efforts to harness consumer power, such as the Fair Trade movement, have been especially effective.

One of the promises of FDI for sustainable development is that TNCs, especially from the OECD, will help to drive up standards in developing countries by transferring both cleaner technology and better environmental management practices.

Empirical studies, however, have failed to find evidence for such a trend. In statistical studies of Mexico (manufacturing) and Asia (pulp and paper), foreign firms and plants performed no better than domestic companies. Instead, environmental performance was found to depend on 1) the scale of the plant (bigger is better); and 2) the strength of local regulation, both government and "informal".[ii]

Many developing countries lack the capacity and/or political will to enforce environmental oversight of industry. In this context, TNCs are able to "self-regulate" and have one of three choices: 1) follow local practice and norms; 2) adopt internal, company-wide standards, either an average or the highest of relevant home country standards; or 3) adopt international standards or "best practice" norms for corporate social responsibility.

In the petroleum and mineral sector, a host of case studies suggest that, on average, TNCs have tended to follow—or even to worsen--local practice.[iii] In all parts of the world, mining operations have generated severe environmental degradation and pollution, including the discharge of toxic substances into river systems, large volume waste disposal, the inadequate disposal of hazardous wastes, and the long run impacts of poorly planned mine closure.[iv] Transnational oil companies have been the target of protest and criticism for widespread pollution and human rights violations in the Amazon region and elsewhere.[v]

In the high tech sector, American and European TNCs tend to adopt either company-wide standards or international "best practice" for environmental management and community consultation. Within the industry, however, there are "leaders" and "laggards".

The evidence suggests that, overall, TNCs perform no better than domestic companies. The environmental performance of a particular TNC in a particular locale depends on: 1) the strength of local regulation; 2) the industry it is in; and 3) the particular company culture with respect to environmental commitment and corporate social responsibility.

(b) Economic Growth and the Environment

One of the potential benefits of FDI is that it stimulates economic growth. Without adequate global and national regulation, however, economic growth is likely to accelerate environmental degradation—even if TNCs are good performers--through scale effects. The experience of East Asia, often described as an "economic success story," provides a tragic example. According to the Asian Development Bank, resource degradation and environmental pollution in both East and South Asia is so "pervasive, accelerating, and unabated" that it risks human health and livelihood.[vi]

The scale impacts of economic growth on the environment derive largely from unsustainable production and consumption patterns. If FDI targets sustainably produced and transported goods and services, then the overall impact--even of rapid and high growth--on the environment would presumably be neutral or low. To date, however, rapid growth has tended to be associated with an increase in unsustainable production and consumption patterns.

While acknowledging that environmental impacts can worsen with an increase in the rate of growth, some economists argue that, over time, economic growth generates environmental improvements. The "Environmental Kuznets Curve" (EKC) posits that environmental quality first worsens and then improves as per capita income (GDP) rises. Reasons include the substitution of less polluting consumer goods; changes in the structure of industry; and greater political demands for environmental regulation. Early studies, including the first study using Mexico City air quality as the environmental variable, put the "turning point" at between US$3000 and US$5000.

If true, the EKC suggests that, to a large extent, the pursuit of economic growth is *itself* a sustainable development strategy. One major concern, however, is that the environmental and resource degradation at lower levels of income often results in *irreversible* losses. Examples include loss of biological and genetic diversity and potable water due to degradation or destruction of "old growth" forests; depletion or destruction of fish stocks due to coastal degradation; and human deaths resulting from severe air pollution.
The validity and credibility of the EKC hypothesis, has been challenged on several counts.[vii] First, evidence is limited to a small number of localized pollutants, primarily sulfur and particulate matter. Second, data comes mostly from developed, rather than developing nations. The handful of studies which rely on data from developing nations have found that evidence for an "inverted-U" relationship is ambiguous. Third, the "turning point" is significantly higher than original estimates--$14,730 and $22,675 for sulfur; $9800 for particulate matter; and $35,000 for carbon dioxide. In one study, a second wave of environmental degradation occurred when per capita income reached $10-15,000.

Most important, many studies have found that other factors are more important than income in determining environmental quality, including political freedom and democracy, population density, industry structure, and historical events (such as the oil price shocks of the 1970s).

(c) Environmental Regulation: Stuck in the Mud?

Environmental and resource management is largely the preserve of nation-states. How does FDI affect national (and-sub-national) environmental regulation? There is evidence that TNCs themselves, wielding their substantial bargaining power, can help to drive local standards up—or down.

Given the absence of global environmental standards, would-be host governments seeking to attract FDI are reluctant to make higher-than-average environmental demands on powerful TNCs, singly or collectively. They may even be tempted to offer lower-than-average environmental demands to enhance the attractiveness of an overall package. Dubbed the "stuck in the mud" problem, the impact of intense global competition for FDI—absent common environmental norms--is thus to inhibit the rise of environmental standards.

There is some evidence that, despite regulators' fears, high environmental standards do not, in fact, deter investors and in some cases, are even preferred by investors. Moreover, with the rise of the global corporate social responsibility movement, TNC and host-government expectations may be changing However, the standard operating practice in government-TNC negotiations over environmental management appears in general to be to avoid changing current practices and pressing for reform.

Overall, an examination of all three of the channels linking FDI and the environment suggests there is no determinate trend: FDI can improve, worsen or have no impact on environmental quality. Other factors—government regulation, the rate of economic growth, company culture, the particular industry in which the FDI takes place, the rules that govern FDI—are key variables.

(d). Mixed Record: The Mexican Experience

For Mexico, FDI was the prize of the NAFTA integration process. The hope was that FDI inflows would greatly increase, stimulating economic growth and bringing social and environmental benefits by absorbing rural migrants—displaced from by agricultural liberalization--into new, higher paying urban-based jobs, and by transferring cleaner technologies and better environmental management practices.

In the event, the results have been mixed. US FDI into Mexico has increased by a factor of ten since 1985, reaching $24 billion in 2001, contributing to a massive influx of internal migrants to urban areas. Between 1980 and 2000, population more than doubled in FDI-laden areas, while the population of Mexico as a whole grew by less than forty percent.

What is less clear is whether the lives of Mexico's working and poor people have substantially improved. According to the OECD, the swollen urban population far exceeds the infrastructure capacity of host communities to manage sewage and waste, provide sufficient water, and protect air quality. Wages in foreign firms are lower than the mean wage in Mexican manufacturing as a whole--and have fallen in real terms by more than 10% since 1987.

Moreover, the large FDI inflows of the last decade may not be sustainable. From the middle of 2001 through the end of 2002, foreign-owned firms dismissed 287,000 workers (or one in five of all such workers).[viii] Mexican analysts worry that US (and other foreign) firms are shying away from Mexico because of sluggish growth in the US--and because of emerging opportunities in China. The environmental benefits of FDI have also been elusive. A World Bank study found no correlation between foreign-ownership and firm-level environmental performance in Mexican industry. Rather, the key variable was the strength of state regulation.

These trends mask some "best practices" that can serve as models for a more comprehensive sustainable investment strategy. Some foreign firms, including Dutch steel companies and U.S. chemical firms, have offered higher wages, better working conditions and/or better environmental standards. Some have also negotiated relationships with host communities for public infrastructure and social services.

Unfortunately, these sustainable development success stories are an exception rather than the rule. Between 1985 and 1999, rural soil erosion grew by 89 percent, municipal solid waste by 108 percent, and urban air pollution by 97 percent. The Mexican government estimates that the economic costs of environmental degradation have amounted to a staggering 10 percent of annual GDP, or $36 billion per year. These costs dwarf economic growth, which amounted to only 2.6 percent on an annual basis.

Unless economic integration is coupled with strong environmental regulation and enforcement, pollution is likely to worsen. Since NAFTA took effect, however, real spending on the environment and has declined 45 percent, and plant-level environmental inspections have shown a similar drop.

4) Sustainable Development and International Law on Foreign Investment

a) The Rules in NAFTA Chapter XI

A careful reading of NAFTA Chapter XI reveals that its rules and mechanisms are poorly drafted and biased in favor of protecting the investor, in disregard of sustainable development

considerations. For example, the rules only provide for investor rights and privileges but not for investor responsibilities, such as mandatory reporting, liability at see, technology transfer, training, etc. Also, the rules provide for host-state obligations but not for the home-state obligations.

Further, the rules fail to protect the interests of non-investors. In fact, Chapter XI does not contain a general exception for measures necessary to protect health, safety, labor, or environmental laws, in the line of GATT 1994 Article XX. Likewise, Chapter XI does not contain clear and enforceable obligations to prevent states from lowering their standards to attract investments.

Besides these general issues, in most cases brought under NAFTA or bilateral investment agreements, investors have asserted claims based on the rules described below.

National Treatment (NT) and Most Favored Nation Treatment (MFN). Under most investment treaties, the host country must treat the foreign investor no less favorably than it treats domestic investors or investors of other State parties in like circumstances. While at first blush this requirement seems unobjectionable, in practice the national treatment obligation is problematic because it requires the comparison of activities that are not necessarily easy to compare. Recent cases under the NAFTA, for example, show that investment tribunals tend to rely primarily on business considerations when comparing domestic and foreign investments, rather than looking into the environmental and legal circumstances. Thus, if a domestic company were to be treated differently from a foreign company because its production process was more environmentally sustainable, the host state might be sued for breach of the national treatment obligation--hardly a result that supports sustainable development policies.

Minimum Standard of Treatment (MST). Many investment treaties include a minimal treatment standard that requires that a host State treat the foreign investor in accordance with an undefinable standard of "fair and equitable" treatment. Traditionally, this type of provision applied only to extreme cases of mistreatment; however, tribunals under NAFTA's investment chapter have interpreted this provision extremely broadly, and have failed to articulate a clear, objective standard. In response to this troubling expansion of the scope of this provision by arbitral panels, the trade ministers of the NAFTA parties issued an interpretive note in July 2001 attempting to curtail extensively broad interpretations.

Performance Requirements. Of particular interest to developing countries, investment agreements prohibit the use of certain performance requirements, such as technology transfer obligations, local hiring and training requirements, and domestic content rules. These have traditionally been used by developing countries to ensure that foreign investment furthered their developmental goals. It is critical that developing countries be able to guide incoming investments toward local and national priorities to further environmentally and socially sustainable development. NAFTA, for example, disallows such performance requirements at every stage of the investment "in connection with the establishment, acquisition, expansion, management, conduct or operation of a foreign investment." This significantly weakens the bargaining position and constrains options of developing country governments to promote national sustainable development goals.

Expropriation. A central provision of NAFTA Chapter XI and other bilateral investment agreements is a prohibition on uncompensated expropriation or taking of investors' assets. Early instruments dealing with foreign investment usually contained provisions regarding "nationalization" and/or "expropriation." These terms were understood to cover direct expropriations of property by the host state through legislative or administrative measures, which resulted in a compulsory transfer of property rights. More recent investment treaties expanded the scope of expropriation to include indirect expropriation, also referred to as "disguised" or "creeping expropriation," the rough equivalent of a "regulatory taking" under U.S. law. In this context, indirect expropriation may also

include actions that fall generally within the police powers of a state. International law and practice appear to exclude the normal exercise of sovereign regulatory powers from the obligation to compensate for expropriation. However, as the case studies below make clear, the tribunals addressing this question have interpreted indirect expropriations to include regulations that aim to protect the environment and public health.

Investment rules thus risk reversing the polluter pays principle --a bedrock principle of both economic efficiency and environmental policy--by requiring governments to compensate investors for the economic costs of complying with environmental regulation. In addition, public interest groups and governments have expressed concerns about the potential chilling effect of such provisions on the ability and willingness of governments to adopt and implement environmental and other public welfare regulations.

In sum, NAFTA CH XI Rules on MST, NT, MFN, Performance Requirements & Expropriation are not an appropriate model because they fail to:

- recognize that the objective of promoting regional investment should be undertaken in the framework of Sustainable Development, articulating not only rights but also responsibilities of investors, as well as host and home states;
- recognize that *bona fide*, non-discriminatory environmental regulation falls under the police powers of the state and does not give grounds to claims of expropriation;
- clarify that the concept of "like circumstances" in the NT and MFN may relate to local environmental characteristics;
- acknowledge that the contribution of FDI to Sustainable Development may be contingent upon performance requirements, including technology transfer, exports, and training.

Dispute Settlement. Perhaps the most powerful element of recent investment agreements is the inclusion of a private right of action for investors. In the past, disputes arising from treaties were primarily resolved by state-to-state adjudication before international arbitral tribunals, claims commissions, or before the International Court of Justice. Since the early 1980s, bilateral investment treaties have introduced investor-to-state arbitration rules under which a foreign investor can directly sue a host state for an alleged violation of certain treaty provisions. As a result, investor-to-state disputes have increased significantly. For example, from its founding in 1966 until 1997, the World Bank's International Center for the Settlement of Investment Disputes (ICSID) handled only six BIT cases. However, in the 2001 fiscal year alone, ICSID had a total of 43 pending cases brought under BITs and NAFTA, a trend that continues to grow.

The investor-state arbitration model, as currently conceived and applied, is inadequate to ensure transparency and balance in the competing interests of relevant stakeholders, including local communities affected by foreign investors. Also, the fact that arbitration panels deliberate in secret raises important public policy questions. Moreover, there is no effective appellate process, the judicial systems of the host countries are bypassed, and the local communities affected by the disputes have no role in the process. Further, individual investors have aggressively argued for expansive interpretations of the substantive rules described above since they are not constrained, as governments are, by the destructive effect on the regulatory authority of overly broad investment rules.

The considerations presented above call for structural reforms in investment disciplines in the Americas. In other words, the NAFTA model should not be utilized, as its rules are ambiguous and biased, and as its dispute settlement mechanism undermines good governance and democracy. Some specific recommendations regarding how investment rules could contribute to sustainable development are offered in the last section of this piece.

b) Three Examples of Investment Disputes in the Americas

Mexico/Metalclad. The Mexican government recently was forced to pay a U.S. company, Metalclad, US$16 million based on the refusal by a local Mexican community to allow Metalclad to operate a hazardous waste facility. The local Mexican community blocked the operation of the facility on an already severely polluted site by denying a required construction permit and later declaring the site an ecological preserve. Metalclad ultimately won the award from an arbitral panel based on violations of the minimum standard of treatment and expropriation provisions of NAFTA's investment chapter. A Canadian court reviewing that decision upheld the award, but found that the Chapter 11 tribunal had exceeded its powers when it ruled that a municipality's decision not to grant a permit to a hazardous waste dump was a violation of "fair and equitable" treatment. More troubling is the tribunal's interpretation of the Mexican Constitution, which rejected the Mexican government's interpretation of its own Constitution.

Bolivia/Bechtel. The Bolivia/Bechtel case illustrates how BITs may be used to constrain policy options of local governments in issues of vital importance such as access to water. In this case, the U.S. multinational Bechtel Corporation is using a Dutch-Bolivian bilateral investment treaty in an attempt to force the Bolivian government to pay roughly US$25 million for claimed losses as a result of events surrounding the privatization of the municipal water system in Cochabamba. Upon taking over the system, the Bechtel subsidiary Aguas del Tunari raised prices for water by an average of nearly a third, causing massive protests and riots. In response to the breakdown in public order, the company withdrew and now blames the Bolivian government for its losses. The arbitral tribunal hearing the case under ICSID rules has declined to provide access to documents and hearings, as well as to allow the participation in the proceedings, to people affected by this failed water privatization scheme.

Methanex. In October 1997, the California Senate adopted a Bill allocating funds for the University of California to conduct an assessment of the human and environmental risks and benefits associated with the use of methyl tertiary-butyl ether (MTBE). MTBE is a methanol-based oxygenate introduced to gasoline for cleaner burning that has contaminated California's groundwater. Based on this study, in March 1999 the Governor of California issued an executive order recording that there was a significant risk to the environment from using MTBE in gasoline in California and banned MTBE from gasoline effective 31st December 2002. Methanex, a Canadian corporation that produces methanol, initiated arbitral proceedings against the United States for alleged violations of NAFTA Chapter XI, claiming damages in the order of $970 million plus interest, besides the costs of the arbitration. The Arbitral Tribunal hearing the case found that the application failed to meet the jurisdictional requirements of the scope and coverage of Chapter XI in relation to measures adopted by Parties, but allowed Methanex to submit a new application focused on the alleged discriminatory intent of the United States. This case clearly shows how foreign investors utilize NAFTA disciplines to claim damages when environmental regulations have the effect of diminishing their expected profits.

III. Overcoming Imbalances: Investment Rules for Sustainability

The shortcomings apparent in NAFTA Chapter XI, both in the substance of the rules and in the investor-state dispute settlement mechanism, call for improved disciplines on investment. These new disciplines should address existing imbalances between the obligations of the home-state of the investor and the host-state receiving the investment, between FDI protections and the conduct of TNCs, and between local communities and foreign investors.

Host State v. Home State Obligations. Current FDI rules as embodied in the NAFTA and many BITs are unbalanced in that only the host-state acquires obligations in respect of the foreign investor. The home-state, which is granting the foreign investor its nationality and potentially its diplomatic protection, does not retain however, under existing rules, the obligation to control the activities of its nationals, to ensure respect of local and international law, or to provide adequate remedy in case of environmental harm. In regard of home-state obligations, two dimensions should be differentiated: obligations assumed by the home-state directly that may attach state responsibility for breach, and obligations regarding the exercise of jurisdiction on the basis of the nationality of the investor.

In terms of obligations directly assumed by the home-state, these should be equivalent to those assumed by the host-states. In the ambit of sustainable development, these obligations should encompass for example, the duty to ensure that the transfer of hazardous materials and technology is undertaken with due diligence and the consent of the host-state. This obligation may apply to chemicals management, the trans-boundary movement of genetically modified organisms, the treatment and disposal of hazardous wastes, etc.

In terms of obligations regarding the exercise of jurisdiction, although home-states may bind their nationals according to the uncontested nationality principle of international law, environmental regulations in these matters are scarce. In part, this follows from the recognition that each State may, by virtue of its sovereignty, determine its own environmental laws and policy. Still, some examples of extra-territorial regulation based on the nationality principle may be found in the areas of bribery, anti-trust and securities regulations, and money-laundering, among others. On the basis of the collective interest in the protection of the environment, home-state regulations may be applied extra-territoriality to ensure that foreign investors comply with basic standards of conduct, such as the disclosure of environmental, social, and financial information to shareholders and stakeholders.

Protections for FDI & Conduct of TNCs. Current investment rules stress the obligations owed by the host-state to the foreign investor, neglecting disciplines regarding the conduct of TNCs. In part, this imbalance is explained in terms of the power of the host-state in its territory, including the use of force, to ensure compliance with its laws and regulations. However, this assumption overlooks the fact that the budget of the State is severely constrained in developing countries, which undermines the effective enforcement of environmental laws in particular. Therefore, safeguards are necessary to ensure that the State retains its ability to regulate for the public good, and that TNCs activities do not undermine sustainable development. Several key investment disciplines move in this direction, including *inter alia*:

- **Admission of FDI**: The existence of a screening process to allow the host-state to determine whether it will or not accept an investment in its territory is critical to preventing negative investments.
- **Transfers of Funds**: The ability of the host-state to control transfers of capital is essential to prevent crashing markets and currencies, particularly for the small economies of developing countries.
- **Exhaustion of Domestic Recourse**: The exhaustion of local remedies is critical to ensure that local investors are not discriminated against, and to provide local judiciaries the opportunity to ensure the rule of law.
- **Non-Interference with Local Affairs**: Rules of conduct to prevent TNCs from interfering in the internal affairs of their host countries may be critical to enhancing democracy and the rule of law.

Local Communities and Foreign Investors. The current investment rules are heavily tilted in favor of the foreign investor, in detriment of local communities. For example, a local community whose environment has suffered harm will find steep obstacles in securing adequate redress. It may

well be that the right to receive indemnification from home-states is a corollary of the obligation by the home-state to control its nationals. After exhaustion of local remedies and in the absence of arbitral proceedings where local communities may collect damages for loss from the home-state, effective legal mechanisms must be established to ensure that investors do not escape liability, including the cleanup of contaminated sites, by relocating in other countries.

IV. Concluding Recommendations.

The preceding sections discuss in certain detail the impacts of FDI on the ability of countries in the Americas to formulate environmental policy and regulation for steering course towards sustainable development. As has been noted, investment disciplines require structural changes if FDI is to internalize its environmental impacts and if economic activity is to remain within the resource base. In turn, these disciplines will only reflect sustainable development considerations if they result from transparent negotiations, open to the participation of the public, that recognize the environmental and social implications of de-regulated investment flows in the Americas.

The previous sections identify a number of areas where change is necessary. The need to balance rights and obligations between States, and between local and foreign investors, was identified as an overarching requirement of sustainable development. To clarify some of the most pressing issues, the *Forum Towards Civil Society Participation in the Americas* convened in Quito, Ecuador, 29-30 October 2002, proposed the following recommendations:

1. Clarify the substantive rules on investment in order to preserve the ability of states to regulate affairs in the public interest;

2. Define the responsibilities of the investors' state with relation to environmental and social performance of its nationals, in particular to avoid double standards on an international level;

3. Create within the framework of the FTAA an open and transparent dispute resolution system among member states, with a right of appeal, and including a fund to cover the costs of litigation where necessary;

4. Ensure the obligation of the parties to not weaken domestic environmental, social and labor-related standards with a view to attracting investment. This undertaking should be accompanied by effective mechanisms to ensure enforcement of environmental, social and labor-related regulations.

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[i] This section draws on Zarsky and Gallagher (2003)
[ii] Dasgupta *et al (*2000)
[iii] See International Right To Know Campaign (2003)
[iv] Sandbrook and Mehta (2002)
[v] Leighton et al (2002)
[vi] Asian Development Bank (2001) p. 2
[vii] All studies in this section referred to in this section are summarized by Stern (1998)
[viii] INEGI (2002)

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