Foreign Investment and Sustainable Development

Despite recent promises of increased direct development assistance, private investment flows are potentially the most significant source of development capital flowing into developing countries: as measured by UNCTAD, foreign direct investment (FDI) expanded in 2000 to a global total of US$1.3 trillion, with the developing countries receiving 19 percent of the total.1

In general, developed countries have dictated the rules or terms for receiving incoming investment through regional and bilateral agreements and conditions imposed by international financial institutions. For example, a "strong" investment chapter was seen as one of the prices Mexico had to pay to secure the North American Free Trade Agreement (NAFTA). Usually justified by a need to protect foreign investors against outright seizure or abusive regulation, international investment rules grant broad rights and enforcement powers to investors, but in the process they restrict the ability of national and local governments to regulate the activities of foreign investors to meet local developmental, environmental, or social priorities. In practice, the "high standard" model of international investment rules has proved to favor the narrow commercial interests of corporate investors over broader societal interests, which is compounded by the failure of existing investment agreements to require even minimum corporate responsibility standards. Many think that the most troublesome aspect of this flawed approach to managing international investment flows is the inclusion of a direct investor-to-state dispute mechanism in some bilateral investment treaties (BITs).

This brief describes the key provisions of the "high standard" model of investment liberalization promoted by certain developed countries and illustrates the danger it presents to sustainable development policies, through the use of several case studies. Finally, suggestions for an alternative approach are outlined.

THE RULES

In most cases brought under NAFTA or bilateral investment agreements, investors have asserted claims based on the rules described below.

National Treatment. Under most investment treaties, the host country must treat the foreign investor no less favorably than it treats domestic investors 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.2 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. Many investment treaties include a minimal treatment standard that requires that a host State treat the foreign investor in accordance with an undefined 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.3 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."4 This significantly weakens the bargaining position of developing country governments to promote national sustainable development goals.

Expropriation. A central provision of 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

1 United Nations Conference on Trade and Development (UNCTAD), the World Investment Report 2001, UNCTAD/WIR/2001 (2001). Developing countries received a peak of 41 percent of global FDI in 1994. In 1999, Official Development Assistance (ODA) by developed countries was around $56 billion, which was only 0.24% of GNP of those countries. Even if developed countries fulfilled the target commitment of 0.7%, the ODA would have been only around $156 billion. See http://www.un.org/esa/fdithemes/ODA-Sub-index.html#Report%20On%20The%20Secretary-General.
4 NAFTA Article 1106.1. Note that, in contrast to other Chapter 11 investor guarantees, the restrictions apply not only to investments of foreign investors of the NAFTA parties but also to investors of non-Parties (although the latter do not have access to the NAFTA dispute settlement mechanism).
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.

**ENFORCEMENT: INVESTOR-TO-STATE 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 arbitration or adjudication 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. Individual investors have aggressively argued for expansive interpretations of the substantive rules described above since they are not constrained, as governments are, by the restrictive effect on the regulatory authority of overly broad investment rules.

**CASE STUDIES**

Canada/S.D. Myers. A panel applying NAFTA's investment rules upheld another U.S. investor's challenge to Canada's temporary ban on exports of polychlorinated biphenol (PCB) waste. PCB wastes are covered by the Basel Convention on the Transboundary Movement of Hazardous Wastes and subject to that agreement's preference for domestic treatment. The panel of investment experts brushed aside this preference, applied a "least trade restrictive" test to the Basel Convention, and asserted, without detailed analysis, that Canada had other, equally effective regulatory options. They held that the export ban violated NAFTA's national treatment obligation.

Bolivia/Bechtel. 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 rather than accept responsibility for its own mistakes.

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 perhaps is the tribunal's interpretation of the Mexican Constitution, which rejected the Mexican government's interpretation of its own Constitution.

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. Yet the U.S. and its allies are seeking to replicate this flawed approach to investment rules in other agreements, including the Free Trade Area of the Americas and the WTO.

**PRIORITIES FOR THE FUTURE**

The WSSD should focus on developing an alternative and more comprehensive approach to investment regulation, which must include the following elements:

- A broader international framework recognizing the importance of FDI to developing country efforts for sustainable development in addition to the needs of private investors;
- Clear minimum standards for corporate responsibility with effective mechanisms for ensuring adherence to those standards;
- Substantive rules that more carefully balance the need to protect foreign investors from mistreatment against the rights of all governments to regulate in the public interest according to national priorities;
- Procedural rules allowing access to international arbitration only upon a showing of exhaustion of local remedies or futility of pursuing such remedies; and

The reform of arbitration mechanisms to ensure that deliberations are undertaken in the light of public scrutiny, with options for participation by interested parties, and with the opportunity for thorough appellate review of panel decisions.

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6. E.g. Metalclad Corp. v. United Mexican States, ICSID Case No. ARB(AF)/97/1 (2000).
7. ICSID 2001 Annual Report, and personal communication with the Deputy Secretary General of ICSID.