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5 The EU's approach to Free Trade Agreements

Investment

This paper forms part of a series of eight briefings on the European Union's approach to Free Trade Agreements. It aims to explain EU policies, procedures and practices to those interested in supporting developing countries. It is not intended to endorse any particular policy or position, rather to inform decisions and provide the means to better defend them. The views expressed in the briefings do not necessarily reflect the views of the publishers.

What's at stake?

For developing countries

Investment flows totalled $1036 billion in 2006, nearly half of which flowed from the EU. Currently developing countries account for around a one-third share in foreign direct investment (FDI). Investment has the potential to contribute to a country's development by providing:

- A source of capital for cash-strapped governments
- Services and infrastructure to fill gaps in the domestic economy
- New export opportunities
- Opportunities for technology transfer and skills upgrading
- Jobs and tax revenue
- Opportunities for local firms to sell goods and services, learn new techniques and encourage entrepreneurialism.

Evidence that investment deals help developing countries attract the right quality and quantity of investment is mixed at best[1]. Traditional international investment agreements are unbalanced, focusing exclusively on investor rights and protection. There is usually no express accompanying recognition of the right of the state to regulate to achieve public policy or development objectives, nor any acknowledgement of the need for obligations to be placed on the home state of the investor to help police corporate misconduct. This entails real risks for developing country governments, as is demonstrated by the explosion in the number of disputes brought by investors under investment agreements in recent years: over 250 known arbitrations have been brought by investors against host states, the vast majority of which have commenced in the last five years. These often result in financial penalties and the reversal of the government's policies.

The benefits of FDI are not automatic, and impacts can also be negative. Much depends on the behaviour of the investor, the state of the local economy and institutional factors. It is at least as important for developing countries to select and manage investment as to attract it.[2]

Investment in trade deals covers Foreign Direct Investment (FDI). This is when an investor from the 'home' state takes a significant share in ownership in a firm in a 'host' state and is involved in the day-to-day running of that enterprise over the longer term. Other types of investment can also be included and are usually covered in Bilateral Investment Treaties (BITS) for example stocks and shares, real estate or intellectual property.

1 Cosbey 2005: International Investment Agreements and Sustainable Development: Achieving the Millennium Development Goals

2 UNCTAD 2005

For the European Union

The EU's new approach to investment in Free Trade Agreements (FTAs) is a response to the perception that 'European investors are discriminated against vis-à-vis their foreign competitors and the EU is losing market shares'. The EU perceives that it is lagging behind the US in terms of the content and regional reach of its investment deals. It aims to target key regions according to their size and level of protection against EU export interests.[3]

3 See DG Trade issues note dated 31 May 2006: 'Upgrading the EU policy' and Global Europe competitiveness strategy

According to the Global Europe competitiveness strategy, Europe's future lies in moving up the value chain in premium goods and services, in particular with services such as telecoms, distribution, finance, transport and environmental services. Investment conditions are key to services industries which often rely on proximity to the customer. As global supply chain management becomes more important, the importance of non-tariff barriers and regulations overseas to the viability of EU industry increases. The EU also believes that FDI leads to increased trade.

Understanding investment texts: Key terms and definitions

International Investment Agreements (IIAs)/ Bilateral Investment Treaties (BITS): IIAs are agreements between two or several countries containing international law guarantees relating to the treatment of each other's investors and investments. These can take the form of BITS – which are agreements between two countries dealing only with investment, designed to promote and protect investment between them or increasingly through investment provisions contained in wider regional trade agreements (RTAs). There are also some multilateral agreements dealing with specific areas or aspects of investment such as the General Agreement on Trade in Services (GATS), Agreement on Trade-Related Investment Measures (TRIMS) and the Energy Investment Agreement (EIA).

Establishment: Establishment is when foreign nationals and companies set up a permanent business presence in a host country either as self-employed persons or by setting up or acquiring local businesses. Traditionally, the EU has allowed host states to retain control over the admission of investments into their territories. On the other hand, the US approach gives rights to investors during the making of the investment. Future investment provisions in EU trade agreements are likely to be influenced by the US approach. For example, a state must provide an investment national treatment and 'most favoured nation' treatment during the pre-establishment phase as well as the post-establishment phase.

Most Favoured Nation (MFN): The MFN rule requires host countries to accord to foreign investors and their investments treatment that is no less favourable than the treatment accorded to investors of any third state. Generally this applies to their treatment after they have been established. However, some IIAs might also extend this right to the establishment of investments, as has been the case of US IIAs and is likely to be reflected in the investment provisions found in future EU trade agreements.

Non-discrimination and national treatment: A national treatment obligation in an IIA requires host countries to treat foreign investors and their investments no less favourably than the investments of their own nationals. It can be applied only post-establishment, or in the case of US BITS and future EU trade agreements/RTAs[4], also for establishment rights.

4 According to the EU's internal issues 'Upgrading the EU policy' dated 31 May 2006

Fair and equitable treatment: The obligation on the host state to accord investments 'fair and equitable' treatment found commonly in IIAs has recently become controversial in view of the debate on its the precise scope. The classic interpretation of the breach of the fair and equitable standard is behaviour or conduct that would clearly shock the impartial observer. However, international law evolves over time, and today, the fair and equitable standard has been interpreted in recent cases to include transparency standards, for example. This makes the scope of commitments uncertain for developing countries, and they may be expected to reach high standards or risk losing disputes.

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Understanding investment texts: Key terms and definitions continued

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Expropriation: Expropriation provisions are guarantees by the host state typically providing that it will not take the investor's investment unless it is for a public purpose and by paying compensation. It is well established under international law that expropriation provisions include both direct and indirect undertakings. Investors have frequently used the 'expropriation' provisions to challenge government regulatory measures under IIAs, including those regulations that were apparently made for the protection of the environment. For example, the banning of a polluting petrol additive (Methanex v. US) and refusing to permit a hazardous waste facility (Metalclad v. Mexico). The current debate in investment treaty law jurisprudence focuses on the distinction between legitimate state regulatory activity in the public interest and those state measures that are to be deemed expropriatory and therefore liable to the payment of compensation under BITs.

Investor–state dispute provisions: IIAs can contain investor–state or state–state dispute settlement provisions. The former are more controversial as they provide investors with the right to enforce directly legal guarantees contained in IIAs against the host state in an international arbitration governed by international law. The provision for direct recourse to arbitration against the host states does not require the involvement of the home state in a claim, nor does it need a prior contract between the investor and the state containing an arbitration agreement. A large number of BITs do not require investors first to use domestic courts to resolve the dispute, and tend to refer to international institutional arrangements such as the ICSID Convention. ICSID was established pursuant to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States 1965 ('the ICSID Convention'), which came into force in 1966. Today, over 150 states have signed the ICSID Convention. ICSID, which is part of the World Bank Group, administers conciliation and arbitration proceedings of investment disputes between governments and foreign investors of states which are contracting parties to the ICSID Convention.

Market access: Market access for investment is equivalent to establishment. This language is used in GATS with regard to establishment (or 'commercial presence' in GATS-speak) of services investors/investments. In this context, market access means that where a country has undertaken commitments it will not impose certain restrictions – legal entity requirements, limitations on share ownership, or quotas.

Non-lowering of standards: These clauses are a recent innovation in IIAs. Their aim is to prevent a 'race to the bottom' in environmental, health, safety and labour standards and taxation incentives in order to attract investors.

Free flow of current payments and capital movements: Under these provisions, host governments usually commit not to restrict the investor's ability to transfer funds either into or out of the country, for example through limiting access to foreign exchange. Two types of payments are included in these categories: current payments (which include payments for trade and services, income from investments, interest on loans) and capital payments such as liquidation of original capital and capital appreciation.

Performance requirements: Some recent IIAs include express provisions barring or restricting 'performance requirements' beyond those required by the WTO TRIMS Agreement. Host states often impose obligations on foreign investments that oblige the investor to act in a way that is beneficial to the host economy. This includes requirements to employ or source locally, minimum levels of exports, maximum levels of imports, or to transfer technology. However, as such mandatory requirements can also interfere with the economics of an investment some IIAs bar or restrict them.

The legal backdrop: What WTO rules and BITS mean for investment in Free Trade Agreements

There is no WTO requirement for countries to include investment in Free Trade Agreements.

In fact, countries have found it difficult to set up a multilateral framework on investment, as is demonstrated by the failure of the OECD's Multilateral Agreement on Investment in 1998 and the rejection by developing countries of investment as part of WTO negotiations in 2003.

Some developing country WTO members already have some commitments on investment at the WTO notably through the agreement on Trade Related Investment Measures (TRIMS) and the General Agreement on Trade in Services (GATS) agreements. TRIMS commitments mean countries cannot use certain measures that are perceived as barriers to free trade, for example local content performance requirements. Least developed countries (LDCs) are currently exempt from TRIMS disciplines and they are attempting to extend this exemption in current WTO talks.

Developing countries that have made commitments under 'mode 3'[5] in different service sectors under GATS have essentially agreed to allow foreign investors in those sectors without using quotas, prohibitive licensing requirements or other measures deemed to restrict trade. These commitments are subject to any limitations they have put in place and certain other safeguards and exemptions allowed under GATS. Neither of these agreements constitutes a comprehensive set of rules on investment liberalisation and protection.

5 For further details see Briefing 4, The EU's approach to FTAs: Services

Although there is no multilateral agreement on investment, many developing countries have already made far-reaching commitments, often to EU member states, via bilateral investment treaties (BITS). These are reciprocal investment promotion and protection agreements between the two states. Common provisions are an assurance to provide compensation for expropriation and fair, equitable and non-discriminatory treatment. They usually provide for investor–state arbitration provisions. The EU is moving from fairly light investment provisions to more ambitious investment chapters as part of its FTAs, and the co-existence of these two sets of agreements will have implications for some countries.

Analysing offensive and defensive interests: Some questions to ask

What the European Commission might want and what this might mean for development

Judging only from past practice, the European Commission (EC) looks unlikely to seek far-reaching investment commitments in its negotiations on FTAs. Until recently, investment provisions were very shallow. For example, they did not provide market access or pre-establishment rights, and only weak investor protection provisions, if any. As the EC's internal issues paper shows, this is not likely to continue. A new, more ambitious approach is on the cards to compete with US NAFTA-style investment chapters, that will consolidate and build on what has gone before. These documents proposed a "minimum platform" for investment in new FTAs. The following table summarises the main likely aspects of new EC investment deals and their implications for development.

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Issue	Examples of text language	Development implications
Non discrimination	'... each Party shall grant to establishments and investors of the other Party treatment no less favourable than that it accords to its own like establishments and investors'.	This provision requires governments to treat foreign and local firms equally. It prevents governments imposing conditions on foreign investors which would make them contribute to local development, for example requiring them to partner with local firms, use local suppliers, or export a given proportion of their production. It also means that governments might find it more difficult to provide more favourable treatment to particular local industries, for example to help disadvantaged groups or regions, or to encourage strategic local industries.
Market access	See Most favoured nation relating to establishment below:	
Free flow of payments and investment-related capital movements	'... undertake to impose no restrictions and to allow all payments for current transactions between Parties to be made in freely convertible currency.' '... undertake to impose no restrictions on the free movement of capital relating to direct investments made in accordance with the laws of the host country... and the liquidation and repatriation of capitals and any profit stemming therefrom.'	Especially without any safeguards or exemptions relating to balance-of-payments difficulties, liberalisation of the current account can lead to financial instability, as demonstrated by the East Asia Financial Crisis in 1997. Foreign investment increases the potential for capital flight from developing countries, especially if linked with a liberalisation of capital movements. Even legal methods relating to transfer pricing, can lead to developing countries losing valuable finances that could be harnessed for development. Co-operation and information exchange between partners for more transparent company reporting of profits and transactions would be more beneficial.[6]
Most favoured nation relating to establishment	'With respect to any matters affecting establishment...shall accord to the Community's establishments and investors a treatment no less favourable that that they may accord to any third country with whom they conclude an economic integration agreement after the signature of this Agreement.'	Depending on any reservations or exemptions that the country lists at the time of negotiating the agreement, this would limit the government's ability to screen and select investors. It would also limit the government's ability to choose with which countries it would like to integrate trade most or first. It would have to offer to the EU investors the same terms as to any preferred partner, for example within its own or neighbouring regions. In recent EPA deals, the EC has made a concession on this point, allowing countries to offer more favourable terms to any country that is not a 'major trading nation' (defined as an industrialised developed country or one that has one per cent or higher share of world merchandise exports).
Non-lowering of standards		These clauses can prevent countries competing with respect to labour and environmental standards or tax incentives, for example. They do not however address the problems relating to company behaviour forcing down these standards. They can also place limits on a country's policy choices and its right to change affected regulations. They also do not give countries the right to raise these standards, should they consider it beneficial to do so. This right may be effectively undermined by other provisions in IIAs, especially investor protection measures in BITS.
In-built agenda	'With a view to the progressive liberalisation of investments, the Parties shall review the investment legal framework, investment environment and the flow of investment between them consistent with their commitments in international agreement no later than .. years after the entry into force of this chapter.'	This is a binding commitment (indicated by the use of 'shall' rather than 'should') to review not only the implementation of the investment deal, but also the whole investment environment – which could be very broadly interpreted to include also general economic conditions, including infrastructure, credit provision and labour regulations, etc. The review is only to seek further liberalisation and does not allow for any rollback of commitments in the light of unintended adverse impacts on development, or for other measures to be upgraded, for example investment promotion measures by the EC or co-operation on policing the behaviour of EU firms in host markets.

The content of EU chapters in FTAs have implications beyond their own application, owing to their co-existence with EU member states' BITS. The EC has made it clear that it will not use the opportunity of negotiating more substantive EU-level FTA chapters on investment to revise EU member states' BITS or to address some of their more detrimental aspects with regard to development or their imbalanced character (that gives rights only to investors and responsibilities only to the host state).

6 Christian Aid 2006, 'Haemorraghing Money: A briefing on capital flight'

Instead, EU-wide deals will 'complement' these BITS provisions and in effect increase the scope of protection for EU member states by creating two parallel regimes of commitments of potential host states, one under BITS, the other under the EU FTA.

The new EU minimum platform proposes pre-establishment provisions for national treatment and MFN treatment, and therefore is a step up from EU member states' BITS, which usually do not contain investment liberalisation provisions (i.e. those providing for treatment at the pre-establishment phase). However, at the same time, the EU minimum platform has important features associated with BITS missing (including post establishment MFN, compensation for expropriation and, critically, an investor–state arbitration mechanism) which are found usually in BITS. Therefore, the benefit of the EC minimum platform proposals will be the greatest for those EU member states with BITS, as they would then get both pre-establishment and post-establishment protection. EU member states without BITS will also benefit from the pre-establishment national treatment and MFN provisions in the EU template, although they will not have the benefit of important BITS protections such as compensation for expropriation, post-establishment MFN treatment, fair and equitable treatment and an investor–state arbitration mechanism for enforcement of such rights, as the EU FTAs do not contain such provisions.

The implication is therefore that states considering signing up to an EU FTA that includes MFN provisions, must also consider the effect of extending the terms of their other international agreements to all EU member states.

Making trade offs – analysing what's on offer from the EU

As investment chapters of FTAs tend to be largely reciprocal, developing country signatories will benefit from the same terms and access to EU markets that they will also need to deliver. However, these rights are effectively imbalanced as the EU tends to be by far the most dominant source of investment and relatively few developing countries can set up shop in Europe.

In signing up to investment deals, developing countries can be giving up significant flexibility in selecting and managing investment, and therefore need to be sure that trade-offs are sufficiently weighted in their favour.

Developing country interests with respect to investment deals tend to be somewhat different from those of the OECD home-country markets:

- Developing countries might be interested in increasing investment in their markets. Investment agreements by themselves do not do this and investment promotion provisions tend to be limited and weak.
- Developing countries might be interested in closer co-operation to improve policing of the conduct of European firms in their markets, for example with regard to taxation and financial reporting, anti-corruption, or compliance with the OECD guidelines for multi-national enterprises.
- Developing countries might also be interested in development co-operation to help local firms to benefit from the presence of foreign firms or to ensure that institutional and regulatory capacity is sufficiently developed to properly manage foreign investment.

The International Institute for Sustainable Development (IISD) model investment treaty gives other ideas on useful alternative provisions that could be included in deals involving developing countries.

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Important information and where to find it

For background on investment agreements, terminology and practice:

UNCTAD Series on issues in International Investment Agreements available at
www.unctad.org/Templates/Page.asp?intItemID=2322&lang=1

UNCTAD list of BITS by country
www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1

Information on disputes
www.worldbank.org/icsid
www.lcil.cam.ac.uk/publications/icsid_reports.php
www.investmentclaims.com/oa1.html
www.ita.law.uvic.ca

Case Studies and analysis
www.iisd.org/investment (International Institute for Sustainable Development)
www.somo.nl

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The EU FTA Manual is a series of eight briefings on the European Union's approach to Free Trade Agreements.

1. Introduction: Tackling EU Free Trade Agreements
2. Inside European Union Trade Policy
3. The EU's approach to Free Trade Agreements: Market Access for Goods
4. The EU's approach to Free Trade Agreements: Services
5. The EU's approach to Free Trade Agreements: Investment
6. The EU's approach to Free Trade Agreements: Competition
7. The EU's approach to Free Trade Agreements: Government Procurement
8. The EU's approach to Free Trade Agreements: Intellectual Property

We will be updating these briefings as negotiations and understanding progress, and would welcome your feedback.

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