REGULATION OF FOREIGN INVESTMENT

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Summary

Regulation of foreign investment at the international level is scarce. What exists for the most part is regulation of state behaviour towards foreign investment. Hundreds of bilateral and multilateral treaties attempt to regulate that behaviour, either exclusively or in combination with other matters, typically trade relations. The provisions of these treaties apply equally to the treatment of investment by nationals of either party in the territory of the other party or parties. However, they are mostly applied, and their standard forms are drafted by developed country parties with the intention to apply, to investment by nationals of the latter countries in developing countries. Several attempts by the OECD, largely a developed countries' organization, to reach agreement among its members on a convention on the treatment of foreign investments have not succeeded. A major developed country withdrew from the latest exercise on the basis that it constituted an encroachment on its sovereignty. However, the great number of investment treaties in force and the noted similarity in their provisions may in due course contribute to the development of international customary law on the rights of foreign investors generally and the obligations of states towards them. Some such customary law may already be found under the rubrics of state responsibility for the treatment of aliens and economic human rights law. Yet, there does not seem to be any binding international rules, customary or otherwise, regarding the obligations of foreign investors or their home states toward the investment-receiving (host) state, with the exception of the indirect regulation through recent anti-corruption conventions. Only guidelines and other soft law instruments have at the international level attempted to regulate foreign investors' behavior and some of these, as will be shown, remain in draft form. Indeed several types of non-binding principles, standards, norms and recommendations provide "codes of conduct" for foreign investors, especially transnational (or multinational) corporations. The World Bank Guidelines on the

Treatment of Foreign Direct Investment, adopted in 1992 provide a primary example due to their impact on national legislation even though they mainly address state actions and omissions. The bulk of regulations applicable to foreign investment is to be found in domestic legislation and regulations which in many respects apply equally to national investment. However, in spite of common perceptions to the contrary, foreign investors in developing countries often receive more favorable legal treatment than that accorded to national investors, if not by virtue of treaties concluded with the investors' home countries, then by contractual arrangements or special legislation (the latter being not uncommon with respect to large foreign investments). Although differentiation in treatment in favor of foreign investors might be understandable in specific areas such as capital repatriation, income transfers, and international arbitration, discrimination against national investors as a general matter is likely to distort the investment climate.

Most foreign investment (about 75% in recent years, except for 1997, when it declined to 64%) takes place among developed countries. In developing countries, both foreign direct investment (FDI) and foreign portfolio investment have witnessed a great expansion during recent decade, although net capital market flows (including foreign commercial bank lending, bond financing and international portfolio equity), have significantly declined after the 1997/98 Asian crisis. Net FDI flows to these countries grew from some $8 billion in 1984 to $24 billion in 1990, $131 billion in 1996, $170 billion in 1997, then $192 billion in 1999, equal to 2.8% of these countries' combined GDP in the last year. By contrast, net international capital market flows to the same countries, after reaching a peak of $103 billion in 1997 (from a low $8.4 billion in 1984 and $18.5 billion in 1990) plummeted to $19 billion in 1999. Net equity flows reached $27.6 billion in the latter year, an increase of $15 billion over 1998, but this was more than offset by a sharp decline in net foreign bank lending, (from $44.6 billion to minus $11.4 billion). The end-result was a decline in the overall size of net long-term private flows to developing countries on the order of 65.2 billion between 1997 and 1999. The greater resilience of FDI flows [in spite of the large drop in their growth rate since 1997] compared to capital market flows during the financial crisis is partly due to the fact that FDI is more responsive to long-term growth trends than to short-term changes in financial returns.

The steady rise in FDI in recent years is associated with the greater stability in macroeconomic policies, liberalization of investment and trade regimes as well as the strengthening of the legal and institutional frameworks in host countries. A recent study has empirically confirmed that improvement in the legal and regulatory framework can have a significantly positive impact on FDI. The following analysis describes the evolution of such frameworks at the domestic and international levels.

1. Domestic Regulation

The right of a state to control the entry of foreign investment and to exercise jurisdiction on the activity of foreign investors in its territory is firmly established in customary international law, as an attribute of state sovereignty, or more precisely, its territorial jurisdiction. This right is only qualified where the host state has entered into treaty commitments that guarantee to foreign investors rights of entry, establishment or a certain treatment, and by general international law rules regarding treatment of aliens.

As mentioned, the 1990s witnessed immense proliferation of treaties on promotion and protection of foreign investment.

Although the right of free entry and establishment is not usually addressed in these treaties, they have, on a global plane, marked a trend of progressive liberalization of the international legal regime on investment. The current network of international law instruments has greatly influenced the content of national laws and policies on foreign investment. National investment regimes have also been affected by the efforts of many international organizations to reconcile the complex interests involved in the relations between foreign investors and their host states. In an economic climate of increased competition for investment funds, in 1994 alone some 15 nations adopted new statutes on foreign investment; another 35 continued the trend in the years that followed.

The legal approaches followed by countries in shaping their foreign investment regimes vary widely depending on domestic political considerations, economic theories, developmental objectives, and perceived national interests. Developed countries generally do not have specific laws for the encouragement and promotion of foreign investment, although such laws exist in countries such as Australia, Canada and New Zealand. Legislation and regulations dealing generally with investment matters in these countries do exclude, however, foreign investment in certain areas. By contrast, specific laws regulating foreign investment abound in developing countries. Based on the policies they reflect, the national foreign investment statutes drastically differ in two general groups of countries.

1.2 Regulation in Inward-Looking Economies

Restrictive policies in the first group are expressed in strict controls over the entry and establishment of foreign investment, the levels of capital which foreign investors are permitted to invest and a myriad of performance requirements. Under such controls, the admission of foreign investment is typically subject to various "screening" procedures, licensing requirements and several approvals by the host state's central and local authorities. The procedures are frequently cumbersome and based on rules that are vaguely formulated, allowing for significant measure of administrative discretion. Transfer of capital and earnings is subject to general currency controls and the employment of foreign labor is tightly restricted. Performance requirements usually include minimum local inputs, export ratios and/or local employment ratios. The legal approach to attracting foreign investments in certain sectors is incentive-based. Statutes of this kind emphasize fiscal (tax exemption) or other incentives to attract and channel foreign investments to certain areas or predefined sectors of the national economy. Such approaches have been proven to distort global flows of foreign investment, while bringing little or no benefits to the economic development of the host country.

Regulation of foreign investments under statutes of this kind are clearly meant to restrict the right of foreign investors rather than to facilitate the exercise of such rights. Although general legal guarantees usually stipulate for "fair" or "appropriate" compensation for the taking of foreign property by the state, such statutes remain vague or silent on the issue of valuation of such property. Only a few of such statutes grant recourse to legal process for challenging the lawfulness of expropriation as well as the amount of compensation. Reflecting domestic policies of close government control over foreign investment, the dispute settlement provisions of such statutes refer only to local courts or local administrative boards.

In recent years, however, countries that have traditionally maintained incentive-based, state-controlled regimes on foreign investment have enacted new legislation that has significantly deregulated investment procedures and have brought down controls on investment. Other such countries have gone further and have adopted legislation, which reflects new, outward-looking approaches to foreign investment.

1.2 Regulation in Outward-Looking Economies

The foreign investment statutes in this group of countries reflect market-oriented approaches to foreign investment, allowing in principle for open admission of foreign investment, subject to specified exceptions. In some of these statutes, the exceptions have been framed in broad terms to assure protection of the host state's fundamental interests such as national security, public order, protection of the environment, public health and the like. In other statutes, the exceptions have been listed in so-called "negative lists" of areas of the national economy where the foreign investment is either absolutely prohibited or only partially permitted under specified circumstances. Some statutes also provide for a one-stop shop where all approvals required, including for tax exemptions, are obtained through one agency. Others sanction approval on a no objection basis within short periods.

No national legal regime is, however, completely free from limitation on the entry of foreign investment. To the extent that screening is maintained in such statutes, it generally applies only to investment activity in areas covered by statutory exceptions. State intervention under such regulatory regimes is usually restricted to preventing market abuses and safeguarding perceived national interests. Statutes of this kind are generally characterized by well-defined rules allowing for higher levels of predictability. For instance, such statutes may require that a reasoned decision be rendered if admission of the investment is denied, or may provide for appeal procedures.

As foreign investment statutes of this type emphasize the role of market forces, foreign investors are commonly accorded national treatment. Only a few statutes employ a different formula, such as "fair and equitable treatment," which is more commonly used in bilateral investment treaties. The right of the foreign investor to remit capital and profits is normally not subjected to conditions. Performance requirements are rare and a large measure of labor mobility, especially in terms of employment of foreign managers and experts, is also allowed. Although absolute statutory guarantees against expropriations are rare (e.g. in Egypt), the foreign investment statutes of this kind offer strong legal assurances of protection from expropriation by stipulating in explicit terms the circumstances under which the expropriation may be effected and specifying the rights of foreign investors in such circumstances. The provisions on valuation and compensation for expropriation usually refer to the fair market value of the expropriated property at the time of the expropriation.

Provisions on dispute settlement are also commonly included. Some statutes that provide reference to different forms of international arbitration, including ICSID, couple the reference with a stipulation of the state's advance consent to one or all forms of international arbitration listed in the particular provision (e.g. in Kyrgyz Republic, Lithuania, and Georgia). Other statutes require that such consent be the subject of a special agreement between the parties. The most recent foreign investment statutes of this type safeguard the host state's obligations in regard to dispute settlement under bilateral or multilateral investment treaties.

The trend through the 1990s has been towards greater deregulation of national and foreign investment regimes. Many countries have in this respect already abolished overly protective domestic investment policies and have changed their laws to provide a more open and tolerant legal framework on foreign investment. Legal concepts or standards that have been developed in the framework of bilateral or multilateral international arrangements have greatly influenced national investment legislation. By complying with commitments undertaken under such arrangements, countries have also gradually moved towards progressive harmonization of the domestic legal standards of treatment of foreign investment.

2. International Regulation

2.1 Bilateral Investment Treaties

The first modern bilateral investment treaty (BIT) was concluded in 1959 between Germany and Pakistan. Over the decades that followed an increasing number of European countries concluded such treaties with developing countries. By the mid- to late-1980s, BITs came to be universally accepted instruments for the promotion and legal protection of foreign investments. BITs are no longer concluded exclusively between capital-exporting and capital-importing countries; an increasing number of them began to be concluded among developing, normally capital-importing countries (and transition economy countries).

The consolidation of certain core provisions in BITs points to what may be called the "first generation" of BITs. The greatly expanded treaty practice since the late1980s, however, has led to refinement in the drafting of BIT provisions and in some cases to their reformulation as instruments of investment liberalization policies.

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