

# trade hot topics

## A Commonwealth Guide on International Investment Agreement Provisions Promoting Sustainable Development

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### Background

International investment law consists primarily of a dense web of more than 3,000 international investment agreements (IIAs) involving 170 countries. While many of the 'core obligations' in these agreements have changed relatively little over time, some states have recently begun to rethink what obligations an IIA should include.

Traditionally, IIAs have been negotiated between developed and developing countries. Developed country parties have been primarily concerned about protecting their investors from discriminatory or unfair treatment by host developing countries. In contrast, developing countries have entered IIAs with the hope that in-bound foreign investment from developed country partners will be encouraged because the investor protection provisions in these treaties guarantee certainty and predictability in host state domestic regimes, especially when backed up by the right of investors from the other party state to seek relief through investor-state dispute arbitration if the host state fails to provide the mandated protection. The prospect of increased investment inflows in practice, however, is only an incidental and uncertain result of protecting investors. As well, attracting investment is not an end in itself. To be desirable, investment should contribute positively

to host country development. Most existing IIAs are not designed to achieve development outcomes. Studies attempting to find a clear link between foreign investment and development have been inconclusive.

Increasing dissatisfaction with existing investor protection based IIAs is encouraging many states to consider new approaches to IIAs that will help to ensure that they do a better job of promoting foreign investment and contributing to the achievement of host state development objectives. The Commonwealth Secretariat is developing a guide to IIA provisions that reflects such a new approach to investment treaty obligations. It provides a discussion of the costs and benefits of different IIA provisions and samples of provisions that are designed to promote sustainable development in host states. Its practical goal is to provide a tool for use by trade and investment negotiators in developing Commonwealth member countries, particularly small states, least developed countries (LDCs) and small, vulnerable economies. In the remainder of this article the factors favouring the adoption of a new approach to IIAs and the particular approach taken in the Commonwealth Guide are discussed.

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## Dissatisfaction with existing IIA models is growing

The consensus on what obligations should be included in an IIA is beginning to fray in two main ways: (i) an increasing number of investment treaties are being negotiated between developing countries and these treaties do not consistently reflect the core investor protection obligations traditionally found in IIAs; and (ii) some developed countries have sought to rebalance the provisions in their treaties to better preserve host state sovereignty to regulate. In part, the burgeoning number of investor-state arbitrations under IIAs is driving this reconsideration of traditional IIA obligations.

According to UNCTAD, one of the dominant trends in IIAs signed in the last few years has been the increase in the number of treaties entered into between developing countries. Twenty-seven per cent of IIAs signed in 2007 were such so-called South–South treaties. Some of these agreements do not contain what have been considered core IIA obligations. For example, there is no most favoured nation obligation in the investment chapter of the India–Singapore Comprehensive Economic Co-operation Agreement. As well, some of these treaties contain a variety of innovative features that go far beyond investor protection to address the development consequences of investment. The Common Investment Agreement entered into in 2007 by the 19 member states of the Common Market for Eastern and Southern Africa (COMESA) includes a mandate for a committee created under the agreement to make recommendations to member states with respect to ‘the development of common minimum standards relating to investment in areas such as: (i) environmental impact and social impact assessments; (ii) labour standards; (iii) respect for human rights; (iv) conduct in conflict zones; (v) corruption; (vi) subsidies’.

At the same time, many developed countries, including Canada and the USA, have changed their investment treaty models to redefine the balance between investor protection and the host state’s sovereignty to regulate with a view to securing greater regulatory flexibility. In the United States, a new review of its 2004 model treaty began in 2009, reinvigorating debate in that country regarding whether the changes made in the 2004 model struck the correct balance in this regard. To date, most of the rebalancing that has taken place has been limited to reformulating core obligations, like national treatment and prohibitions on

expropriation without compensation, and adding exceptions to preserve host state policy-making flexibility in specific areas. Some treaties, however, have adopted new kinds of provisions that relate to subjects not traditionally covered by IIAs and are directed to the development impact of foreign investment. The recent European Union–CARIFORUM Economic Partnership Agreement, for example, expressly obliges the parties to co-operate on and take such measures as may be necessary to prevent investors from engaging in bribery and corruption, to ensure compliance with core labour standards and to establish local community liaison processes, especially in projects involving extensive natural resource-based activities.

Some of this evolution in IIA obligations is being driven by the explosion of investor-state arbitration cases. In 2008 alone, at least 30 new cases were filed, bringing the total of known treaty arbitrations to 317, involving at least 77 states. In most cases (92 per cent), claims have been by investors from developed countries against developing countries. About half of the cases decided so far have found in favour of the investor based, in some cases, on broad interpretations of vaguely worded IIA provisions, especially the obligation commonly imposed on host states to provide investors with ‘fair and equitable treatment’. Another troubling aspect of these cases has been a lack of consistency in tribunal awards creating further uncertainty regarding the scope of IIA obligations.

Surprising interpretations, the cost of the investor-state process and some very large awards against developing countries have caused some states to revise their investment agreement models, and even to reconsider the desirability of investment obligations backed up by investor-state arbitration. This trend is most pronounced in Latin America where 11 bilateral investment treaties were denounced by states in 2008.

## IIAs are not succeeding in attracting investment to host states

A better understanding of the effects of IIAs on investment flows is encouraging a reconsideration of what obligations investment treaties should include.

Almost all developing countries view investment inflows as critically important for their growth. Since 1994, direct investment has represented the largest component of total resource flows into developing countries – exceeding inflows from

other private sources, like loans and portfolio investment, and public sources, such as overseas development assistance (ODA). Unfortunately, this aggregate statistic masks the significantly uneven allocation of investment flows. Direct investment has been concentrated in a relatively small number of countries, mostly in Asia, including Singapore, India and Malaysia. In many African countries and LDCs around the world, ODA remains the largest source of external finance. Recent investment activity driven by the search for new resource wealth has passed some countries by entirely.

Even overall investment flows to developing countries have worsened in the wake of the global financial crisis, falling by 39 per cent in 2009 following six years of sustained growth. In part, this may be a result of the adoption of protective measures in host countries responding to the crisis. UNCTAD has reported, however, that the majority of state measures in the last year related to investment were intended to liberalise the conditions for investment or to promote investment directly. The persistence of pro-investment measures suggests a continuing recognition of the important role that foreign investment can play in contributing to economic development despite the crisis.

But while current investment treaties have provided effective investor protection, they have not proven successful in inducing flows of foreign investment to the developing countries that sign them. Empirical studies have not demonstrated consistently that there is a strong positive correlation between signing an IIA and attracting investment inflows. New approaches are needed to improve the prospects for IIAs to encourage investment.

### **Attracting investment is not sufficient to promote sustainable development**

Even if IIAs did encourage inflows, foreign investment alone does not guarantee sustainable development. Studies which have attempted to find a clear link between foreign investment and development have been inconclusive. There is no doubt that foreign capital can contribute to economic growth and poverty reduction by supplementing local sources of investment and increasing employment and local tax revenues. As well, it can have a variety of positive spill-overs in terms of improved local productivity and innovation and the transfer of new technologies and production and management techniques. There can also be costs. Domestic investment may be crowded out and domestic competition and

entrepreneurship may be suppressed. Investment may worsen income inequality and encourage reliance on the exploitation of local natural resources at the expense of the development of other productive sectors of the economy. In some cases, the activities of foreign investors have had a negative impact on human rights and the environment. The risk of negative effects may be greatest in relation to investment in extractive industries, the most important sector for foreign investment in many developing countries.

Host states need robust and transparent domestic regulatory regimes to ensure that the development benefits of foreign investment are realised and any attendant costs minimised. Many developing countries, however, do not have such a domestic regime and lack capacity to develop one. In some developing countries, the challenge of putting in place a stronger and more effective regulatory regime is further complicated by rent seeking behaviour on the part of government officials and others who benefit from the existing regime.

International investment rules could do more to ensure that foreign investment will contribute to development than simply encouraging investment. Existing forms of agreement, however, are not well adapted to this purpose. As noted, IIAs focus on the protection of investors. Protection obligations represent constraints on domestic policy-making that increasingly have been the subject of concern among developing countries, especially when the constraints may be the basis for a compensation claim in binding investor-state arbitration. More important, existing IIAs contain no positive obligations on states or investors to support investment-led development.

### **The need to create a positive role for IIAs in investment-led development**

Reform to the international financial architecture and a successful conclusion to the Doha Round of World Trade Organization negotiations would contribute to a stronger and more stable basis for continuing investment in developing countries. But the ongoing failure of the international community to deliver results in either of these areas means that renewed focus must be placed on other strategies, including IIAs.

Traditionally the key benefit of IIAs is that they give credibility to host state commitments not to treat investors unfairly or in a discriminatory fashion and so, in theory, encourage stable, long-term

investment flows. IIAs alone, however, can never be a sufficient policy instrument to attract foreign investment. Other host country characteristics, such as the size of the domestic market and local natural resources, play a more powerful role. As well, states have alternative ways to make secure commitments to investors. For example, commitments to particular investors can be made in contracts.

Nevertheless, it is possible to imagine a new approach to IIAs that would result in a larger and more positive role for such agreements in development strategies. The concerns regarding the existing regime identified above suggest some of the areas where change is needed: (i) existing IIAs have created exposure to costly litigation leading to sometimes unanticipated and onerous restrictions on government action; (ii) the evidence regarding the ability of IIA commitments by a state to induce foreign investment into the state is weak; and (iii) IIAs fail to address the development dimensions of investment. The Commonwealth Guide discusses and provides specific examples of how IIAs may be adapted to respond to these concerns.

### The Commonwealth Guide to International Investment Agreement Provisions

The Commonwealth Guide is intended to provide a fresh approach to IIA obligations that will assist developing countries to negotiate investment treaties that promote their sustainable development. It provides a commentary on the costs and benefits of different versions of IIA provisions typically found in existing treaties and samples of provisions that are designed to promote sustainable development more effectively than those in most existing IIAs. There are three key elements of the Commonwealth Guide's approach.

- *Modify core investor protections*  
Developed countries view many of the traditional core obligations in IIA practice as necessary to provide adequate protection to their investors, including national treatment and protection against expropriation without compensation. These substantive obligations provide strong evidence of host state commitment to investor protection. But these provisions may be drafted to provide greater flexibility to regulate to achieve sustainable development and may be supported by appropriate exceptions and reservations in order to ensure that legitimate state measures intended to promote development are insulated from challenge by investors through investor-

state arbitration claims. Some recent agreements contain new versions of these common IIA obligations as well as broader exceptions to state obligations that reflect a better balance between investor protection and the regulatory freedom of host states. The Commonwealth Guide identifies and provides examples of the best practices that are found in existing treaty models, including the model agreements currently used by Canada, the USA, the United Kingdom and India, as well as the draft agreement that was being considered by Norway in 2008 and 2009, the model IIA prepared by the International Institute for Sustainable Development, and other agreements including a number of IIAs recently entered into between developing countries.

- *Impose obligations on investors' home states (i) to promote investment in host states directly, and (ii) to support the development of robust, transparent and effective regulatory schemes in host states*  
The need for investors' home countries to provide more support in the areas of technical assistance and investment promotion was recognised in the 2002 UN Monterrey Consensus on Financing for Development, and confirmed in the United Nations Secretary-General's review of the implementation of the Monterrey Consensus. Greater technical assistance commitments are needed to respond to chronic under-capacity in some countries if they are to develop effective regulatory schemes characterised by transparency, predictability and freedom from corruption. Domestic regimes with these characteristics will encourage investment (both foreign and domestic) and, at the same time, are more likely to be successful in achieving development objectives. Home state commitments to investment promotion are also needed, such as obligations to provide information about investment opportunities and investment rules in host states and financial support to their investors in connection with investing in host states. Even though such commitments would encourage larger and more consistent investment flows to a broader group of developing countries and ensure that investment activity leads to development, they are rare in existing IIAs. The Commonwealth Guide includes sample provisions that create a framework for obligations on investors' home states to promote investment by their investors in host state parties and to provide technical assistance to support the development of effective domestic regimes

in host states for the assessment and regulation of foreign investment.

- *Impose obligations on foreign investors to respect the environment, human rights, labour rights and rights of indigenous peoples and, more generally, to act in a socially responsible manner*  
The need for greater responsibility to be taken by businesses to complement and support domestic regulation of their activities has been recognised for a long time. New thinking is needed regarding how the benefits of investment agreements may be tied to compliance by investors with widely accepted norms for all aspects of corporate social responsibility. The Commonwealth Guide provides samples of provisions that require investors to conduct a social and environmental impact assessment of their investments in accordance with standards developed by the host state and to agree with the host state on an action plan for implementation of the investment in accordance with the assessment. As well, the Commonwealth Guide provides a discussion of obligations that may be imposed on investors to comply with host state law, and minimum standards for the protection of human rights and labour rights and prohibitions on bribery and other forms of corruption. In order to assist developing countries that may face significant challenges in seeking to regulate the activities of foreign investors, the enforcement of investor obligations through a variety of civil and criminal enforcement mechanisms in both the host state and investors' home state are discussed in the Commonwealth Guide.

To complement these three key elements, the Commonwealth Guide includes sample provisions for state-to-state dispute settlement and investor-state dispute settlement. The ability of investors to seek compensation from states for breaches of IIAs in binding arbitration is often considered by developed countries as necessary to ensure that the protections promised by host countries are provided in fact. The Commonwealth Guide provides examples of various kinds of limitations that may be imposed on access to investor-state arbitration for investors to reduce costs and avoid abuse while preserving the main benefits of investor-state procedures.

The Commonwealth Guide sample provisions are not intended to be prescriptive. Instead, the guide provides a menu of options for developing countries. Each state must determine what bundle of commitments are appropriate given

its unique circumstances, including its policies regarding openness to foreign investment and its capacity to regulate foreign investment. As well, every agreement will reflect the unique result of negotiations between states.

In this regard, the Commonwealth Guide is intended to be a tool to support developing countries in their negotiations. Developed countries typically seek to have developing countries commit to a pre-established model IIA that they have drafted to protect their investors from the actions of host country governments. By providing examples of an alternative text and structure for IIA obligations with supporting analytical commentary, the Commonwealth Guide aims to reduce the inequality of bargaining power between developed and developing countries caused by asymmetries in information and experience related to IIAs and limited developing country resources, with a view to facilitating the negotiation of IIAs that do a better job of promoting sustainable development. While the Commonwealth Guide sample provisions have been drafted with a view to inclusion in bilateral investment treaties, they may be used in other negotiating contexts, such as investment chapters of free trade agreements and economic partnership agreements.

## Conclusions

Developing a new approach to IIAs is not a new idea. In 2005, the International Institute for Sustainable Development suggested a new model with some of the features discussed in the Commonwealth Guide. In March 2010, Angel Gurría, Secretary-General of the Organisation for Economic Co-operation and Development, announced that OECD is considering the feasibility of a non-binding 'Model Investment Treaty' in the interests of reducing drafting and negotiation costs, lowering transaction costs for foreign investors, and encouraging greater consistency and predictability across investment treaties. In his announcement, Mr Gurría emphasised the complex challenges of such an undertaking.

The magnitude of these challenges has been demonstrated by recent events. In 2009, the Norwegian Government decided to give up its effort to develop a new model for its bilateral investment treaties that struck a balance of obligations more favourable to host countries. During 18 months of consultations, Norway received strong criticism of its new draft both from business representatives, who claimed the investor protection provisions were too weak, and others, who argued that they provided

insufficient flexibility for host countries to regulate foreign investors. In the end, Norway decided that it was simply too difficult to draft a treaty that struck an appropriate balance. The member countries of APEC (Asia–Pacific Economic Cooperation) have found it similarly difficult to agree on a model free trade agreement chapter on investment, despite having agreed on 15 chapters on other subjects. The organisation had hoped to adopt the investment chapter at its meeting in November 2008, but, as of April 2010, still had not done so.

In light of these events, negotiating agreements that include IIA obligations applicable to investors and their home states and new versions of traditional core obligations as discussed in the Commonwealth Guide may face considerable resistance. These kinds of obligations represent a break with existing practice. Investors' home states may be reluctant to endorse new kinds of IIA provisions that impose constraints on their investors or broaden host states' regulatory flexibility beyond the limits imposed by traditional IIAs. Equally, host states competing for foreign investment may be unwilling to seek such IIA commitments for fear that they might discourage investment in any way. Nevertheless, adopting some of the new approaches identified in the Commonwealth Guide would help to convert IIAs from a blunt instrument with a single-minded fixation on protecting foreign investors with unclear effects on investment flows, into a more balanced form of agreement that would lay the foundation for bilateral co-operation directed to producing long-term improvements in the investment climate in developing countries, attracting more stable flows of both foreign and domestic investment and contributing to host country development in a meaningful way. This article has argued that the time is ripe for such a change in approach.

# International Trade & Regional Co-operation Section at the Commonwealth Secretariat

This Trade Hot Topic is brought out by the International Trade and Regional Co-operation (ITRC) Section of the Economic Affairs Division (EAD) of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth – an association of 54 independent states, comprising large and small, developed and developing, landlocked and island economies – facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

ITRC is entrusted with the responsibilities of undertaking policy-oriented research and analysis on trade and development issues and providing informed inputs into the related discourses involving Commonwealth members. The ITRC approach is to scan the trade and development landscape for areas where orthodox approaches are ineffective or where there are public policy failures or gaps, and to seek heterodox approaches to address those. Its work plan is flexible to enable quick response to emerging issues in the international trading environment that impact particularly on two highly vulnerable Commonwealth constituencies – least developed countries (LDCs) and small states.

## Scope of ITRC Work

ITRC undertakes activities principally in three broad areas:

- It supports Commonwealth developing members in their negotiation of multilateral and regional trade agreements that promote development-friendly outcomes, notably their economic growth through expanded trade.
- It conducts policy research and consultations that increase understanding of the changing of the international trading environment and of policy options for successful adaptation.
- It contributes to the processes involving the multilateral and bilateral trade regimes that advance the more beneficial participation of Commonwealth developing country members, particularly small states and LDCs.

## ITRC Recent Activities

ITRC's most recent activities focus on assisting member states in the WTO Doha Round and the Economic Partnership Agreement (EPA) negotiations involving the African, Caribbean and Pacific countries (ACP) and the European Union (EU), undertaking analytical work on a range of trade policy and development issues, and supporting workshops/dialogues for facilitating consensus-building on issues of Commonwealth members' interest, exchange of ideas, and disseminating results from informed analysis.

## Selected Recent Meetings/Workshops supported by ITRC

3-4 May 2010: Commonwealth Investment Experts Group Meeting for the Pacific, held in Port Vila, Vanuatu

3 April 2010: Workshop on Developing Supply Chains in the Textile and Clothing Industries in South Asia, held in Dhaka, Bangladesh

15-16 March 2010: Commonwealth Roundtable - Regional Trading & Integration Arrangements, held in Hampshire, UK

2 November 2009: High-Level Meeting for WTO Representative of ACP Missions, held in Geneva, Switzerland

26 October 2009: Discussion meeting with the WTO's Geneva Week Participants, held in Geneva, Switzerland

30 September 2009: WTO Public Forum 2009 discussion session on "The Old and New Challenges to Inclusiveness in a Recessionary Global Economy", held (jointly with CUTS-International) in Geneva, Switzerland

7-8 July 2009: Conference on Managing Regional Integration in South Asia, held in Dhaka, Bangladesh

24 June 2009: Conference on Political Economy of Competition and Regulation in Developing Countries, held in Jaipur, India

23-24 June 2009: ACP Preparatory Meeting for the WTO Second Global Review of Aid for Trade, held in Geneva, Switzerland

15-17 June 2009: Workshop on Strengthening Skills of Government Officials in Sub-Saharan Africa on Commercial Diplomacy and Trade Policy Issues, held in Nairobi, Kenya

10 June 2009: Prime Ministerial Caribbean Banana Policy Review Meeting, held in Castries, St Lucia

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