Investment Liberalization:
Some Key Elements and
Issues in Today’s
Negotiating Context

Howard Mann
The International Institute for Sustainable Development (IISD) is a Canadian-based not-for-profit organization with a diverse team of more than 150 people located in more than 30 countries. As a policy research institute dedicated to effective communication of our findings, we engage decision-makers in government, business, NGOs and other sectors in the development and implementation of policies that are simultaneously beneficial to the global economy, the global environment and to social well-being.

IISD’s work on investment seeks to promote investment as a means to achieve sustainable development. Our balanced and insightful approach is reflected in our widely circulated Investment Treaty News bulletin, and our solid expertise has persuaded tribunals in two cases (under ICSID and UNCITRAL) to grant us precedent-setting standing to intervene in investor-state disputes with broad public policy implications. We have been engaged to act as advisors to several developing countries in the course of their ongoing investment negotiations. Our recent work includes the drafting of a Model Agreement on Investment for Sustainable Development, which has won widespread critical acclaim.

The Centre on Asia and Globalisation is a research institute of the Lee Kuan Yew School of Public Policy at the National University of Singapore. It was established in August 2006 to promote excellence in the governance of globalisation and global issues. It conducts and hosts research and analysis by world-class scholars and policymakers on international institutions, governance, energy policy, and other pressing global concerns.

The Centre’s initial research agenda is focused on two areas: global governance and energy policy. The governance research ranges from inter-government institutions like the World Bank and UN to the less formal but increasingly powerful systems of governance: the role of the private sector and the growth of transnational civil society. The research on energy emphasizes energy security, sustainability, and the making of global energy policy.

In addition to research and publications, the Centre organises seminars, conferences and policy dialogues to explore critical issues related to Asia’s existing and potential roles in defining and managing global affairs. As a convener, the Centre brings together people within the region and from the broader international community to develop solutions to some of the world’s most pressing problems.

The Centre is directed by Dr. Ann Florini, who is Visiting Professor at the Lee Kuan Yew School of Public Policy and Senior Fellow of the Brookings Institution.

Series:

Papers:
- Fair and Equitable Treatment in International Investment Agreements
- Investment Agreements and the Regulatory State: Can Exceptions Clauses Create a Safe Haven for Governments?
- The Expanding Jurisdiction of Investment-State Tribunals: Lessons for Treaty Negotiators
- Investment Liberalization: Some Key Elements and Issues in Today’s Negotiating Context

More information about the Forum, as well as copies of all the event papers, can be found at http://www.iisd.org/investment/capacity/dci_forum_2007.asp
Table of Contents

1. Introduction ................................................................................................................2
2. Background and Approaches .................................................................................... 3
   2.1 Investment Liberalization Provisions ................................................................. 3
   2.2 Performance requirements ..................................................................................... 5
3. What are the Negotiating Options? .......................................................................... 6
   3.1 No Provision ......................................................................................................... 6
   3.2 A provision on Investment “in accordance with the laws of each party” .... 7
   3.3 Cooperation Only Provisions .............................................................................. 7
   3.4 Developing Linkages to Development Provisions in a Sequential Fashion .... 7
   3.5 A Non-binding List of Commitments (advertising approach) ....................... 8
   3.6 A Binding List with Provisions for Unilateral Changes ..................................... 9
   3.7 A Binding List with Provisions for Renegotiating or Approvals Procedures
       for Unilateral Changes ....................................................................................... 9
   3.8 A Provision for Temporary Safeguards Measures ........................................ 9
4. Expansion of Investor Obligations in Pre-Establishment Period ......................... 9
5. Negotiation Strategy and Investment Liberalization .............................................. 10
1. Introduction

This brief paper provides some background on the growing importance of investment liberalization as part of Bilateral Investment Treaty (BIT) negotiations, Free Trade Agreement negotiations with an investment component, and regional negotiations on investment or trade. In all these contexts the role of investment liberalization provisions appears to be growing, making them an emerging critical issue for developing country negotiators.

While customary international law over the past century began to recognize that foreign investors had certain rights of protection under international law once they were established, the right of a foreign investor to enter a foreign country has never existed as a matter of customary international law. Rather, until recent years, this right arose only from the internal law and policy of the potential host state. Following the development of the Washington Consensus economic policies and their adoption by international financial and development organizations, however, a growing number of treaties have included the right of investors from one state party to invest in the territory of the other state party. In the language of investment law and policy, this has become referred to as granting the “right of establishment” or “pre-establishment rights”.

Perhaps the first agreement to include such explicit rights between a developing country and developed countries was the 1992 North American Free Trade Agreement (NAFTA) between Mexico, Canada and the United States. It is no longer unique. A recent UNCTAD study on trends in investment negotiations concluded that:

Traditionally, the great majority of IIAs protected investment only after it was established in the territory of a party. IIAs typically did not grant to covered investors the right to establish investment in the territory of the other party. The new generation of IIAs, however, increasingly provides for liberalization of investment flows.2

While this is not the case for all negotiations, it is now a sufficient trend to require that the issues raised by this trend to be understood and considered.

---

1 The European Union provides an exception to this general situation for investment between the EU member states at various times of its evolution.
2. Background and Approaches

2.1 Investment Liberalization Provisions

There are two broad categories for investment liberalization, as well as two broad approaches. The broad categories are services investment and investment in non-services, or all other sectors. The origin of this division lies in the ability of the Uruguay Round services negotiators to include investment in the services sector in what was to become the WTO General Agreement on Trade in Services under the term “commercial presence” while other investment issues failed to gain a toehold in the Uruguay Round. Since then, the distinction between investment in services and non-service sectors has been maintained, even when free trade agreements include liberalization in both broad sectors. The issues and approaches are, however, the same for both categories.

The two broad approaches have been variously labelled “top down”, “list-out” or “negative list” on the one hand, and “bottom up”, “list-in” or “positive list” on the other hand. In the top down, list-out or negative list approach, all the sectors in each broad category are included in liberalization commitments unless specifically excluded in often complex lists or annexes to the agreement. This is, for example, the approach adopted for investment liberalization in the services and non-services sectors in the North American Free Trade Agreement (NAFTA), which has generally been followed in subsequent US and Canadian investment agreements.

The listing process allows states to exclude whole sectors from the liberalization commitments. In addition, states can have narrower exclusions that allow the continued applications of specific laws that create specific limitations or restriction only on foreign investors in a sector that is otherwise liberalized. For example, State A may allow investments to be made in the agricultural sector, but limit the purchase of farmland to certain areas or sizes or water frontage in order to ensure local farmers are able to maintain landholdings and water rights. Or, State B may allow investments in key sectors up to certain size limits, to ensure that local investors in the same field are not squeezed out. These types of exceptions are included in specific annexes that allow the ongoing application of discriminatory measures even in sectors that have been liberalized more broadly.

In the case of the preservation of certain legal rules in otherwise liberalized sectors, there is often a limitation that any amendments to such legislation cannot be more restrictive than the existing legislation at the time the agreement comes into force.

In summary, the top-down approach has three main components:

- A general obligation to liberalize investment in all sectors (service and/or non-services);
- An exclusion list that excludes the application of this commitment to the listed sectors; and

---

3 The best known example is under the General Agreement on Trade in Services (GATS) of the WTO. Services investment is called “commercial presence” in the GATS, a term used specifically to avoid the term investment. This is found in Mode 3 of “trade” in services under the GATS.
A second list identifying laws, regulations and policies that will continue to apply, even if discriminatory, to liberalized sectors.

The second approach is the bottom up, list-in or positive list approach. It is used, for example, in the WTO General Agreement on Trade in Services (GATS). Under this approach, states party to the treaty must prepare a list of sectors to which the liberalization commitments will apply. This approach leaves more control to the states party, as it puts the burden on each to list the specific sectors that will be covered, rather than list out excluded sectors. This also reduces the chances for errors by the states.

In addition, where a sector is listed for coverage, exceptions for the continued application of specific laws, regulations and policies are also generally made, as in the top down model. This may be in the same annex as the listed-in sectors, or in a second annex. Thus, the top down approach also has three key components:

- A section on what obligations will apply to the listed-in sectors (service and/or non-services);
- A list of the sectors to be covered; and
- A list identifying laws, regulations and policies that will continue to apply, even if discriminatory, to the liberalized sectors.

Two other elements are often associated with both these approaches. One is a provision indicating if and how a state may change its lists, both for sectors and any specific laws or regulations. Whether this can be done unilaterally, must be negotiated, or is subject to some form of penalty may be set out in such a clause. The second is a safeguards clause that allows the temporary suspension of the liberalization commitments if the conditions set out in the safeguards clause are triggered.

It is also worth noting that a number of agreements now also distinguish between levels of government authority in each state party. Some US agreements, for example, include only federal level rules as part of the investment liberalization commitment, leaving state levels of government to continue to apply any restrictions or limitations to investments within their legislative jurisdiction.

It should be noted here that investment liberalization commitments do not mean that no domestic laws are to be applied to the investment, either as it is being made or subsequently. Rather, the commitment is to remove any discrimination between the covered foreign investor and the domestic investors in that sector. As a result, and importantly, the liberalization commitment is often found simply in the national treatment and/or most-favoured nation (MFN) treatment provisions of an agreement. For example, the commitment in Chapter 11 of NAFTA arises in Article 1102, on National Treatment:

> “each Party shall accord to investors of another Party treatment no less favourable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of investments.”

---

4 This is supplemented by similar language in Article 1103 on MFN.
The bolded words create the rights of establishment under NAFTA, subject to the exceptions process through annexes described above. There is no separate article actually titled rights of establishment in Chapter 11 of NAFTA.

It is worth noting that under both these approaches, and in both broad categories of sectors, once an investment is made it is covered by the investor protection provisions of the investment agreement. These will apply to the investment to the extent no exclusion is made in any of the related annexes.

2.2 Performance requirements

Finally, the issue of performance requirements should be briefly discussed. As noted in the UNCTAD study on new generation investment agreements, many governments impose requirements on foreign investors in order to promote specific or general economic spinoffs from the investment in the host state. A still small number of investment agreements have now included provisions designed to prohibit the imposition of such requirements on foreign investors. There is much debate on the utility of imposing such requirements, as well as the wisdom of banning them in investment agreements. This debate is beyond the scope of this paper.

What may be usefully noted here is that the issue of including a provision prohibiting performance requirements is closely associated with the introduction of investment liberalization provisions. The basic theory is that the imposition of performance requirements can be used to frustrate the right of establishment through the back door by allowing governments to impose significant demands that make an investment uneconomical. Even short of this, they may have a significant impact on the viability or profitability of a proposed investment. Finally, some performance requirements may be trade distorting. These are already expressly dealt with in the WTO Agreement on Trade Related Investment Measures (TRIMS).

As noted in the UNCTAD study, most existing investment agreements do not make any reference to performance requirements. Given the traditional approach of BITs not to address investment liberalization, this is not surprising. Some agreements simply make reference to the existing WTO commitments on this issue, restating the obligation to comply with the prohibitions in TRIMS. A third set of agreements, mostly based on the NAFTA Article 1106, do prohibit the imposition of performance requirements, going beyond TRIMS in doing so.

What is important to note here is that if states wish to keep the right to impose performance requirements on investors that have pre-establishment rights, they should do so expressly. This can be done in a general provision that identifies what types of measures and in what time periods may be imposed on an investor that accepts to invest with the awareness of the requirements. Alternatively, the legislative or policy measures under domestic law that allow for the imposition of such requirements can be excluded.

---

5 UNCTAD, supra, n. 2, p. 40.
6 This paragraph summarizes the finding in the UNCTAD report, ibid, pp. 40-43.
from the national treatment and MFN treatment obligations through the annexes discussed above.

A failure to expressly “save” the application of performance requirements will likely lead to violations of the main provisions establishing pre-establishment rights, most notably national treatment and MFN treatment. Negotiators that agree to include investment liberalization provisions must therefore address this issue in one form or another as well.

3. What are the Negotiating Options?

The preceding section describes the two main standard approaches to expressing investment liberalization commitments in an agreement. But are these the only two options?

The goal of this section is to ensure that if developing countries do wish to consider investment liberalization in a negotiation, that they have available to them a range of options that will enable them to ensure they maintain the appropriate policy space to make adjustments needed for the benefit of their economies and sustainable development. This includes options relating to the changing of commitments should they be found to be detrimental to the state involved. (For example, the GATS now requires compensatory liberalization commitments to be agreed if any changes in a commitment are sought.)

There are a range of negotiating options that can, at least notionally, be considered. These include:

- No provision
- A provision on investment “in accordance with the laws of each party”
- Cooperation only provisions
- Developing linkages to development provisions in a sequential fashion
- A non-binding list of commitments (advertising approach);
- A binding list with provisions for unilateral changes
- A binding list with provisions for renegotiating or approvals procedures for unilateral changes;
- a provision for temporary safeguards measures; (ASEAN

Each of these can be considered in turn.

3.1 No Provision

Most BITs do not include provisions on investment liberalization. Primarily, the US and Canadian BITs do so. A growing number of FTAs that include investment provisions do include such provisions, but even here there are examples where this is not included. This demonstrates simply that there is no legal requirement in investment agreements or FTAs to include investment liberalization provisions.
3.2 **A provision on Investment “in accordance with the laws of each party”**

A number of treaties include investment establishment in the treaty by guaranteeing the foreign investor the ability to invest “in accordance with the laws of each party”. In some cases, additional language may set out the requirement for the potential host state to apply those laws in good faith or a similar phrase.

This approach does not constitute an investment liberalization commitment under international law. Rather, it turns the matter back to the domestic law of each party, and simply requires that this law be complied with by each when considering the admission of a foreign investment. However, a failure to comply with that law will constitute a breach of the treaty if there is language clearly requiring the potential host state to comply with its laws. For example, if a government may only discriminate between domestic and foreign investors based on certain criteria under its own domestic law, and it applies other criteria to a potential investment, this could lead to a breach of the agreement.\(^7\)

A variation on this theme has been proposed in some instances, requiring states not to add any new constraints to its domestic law as it relates to future investments by covered investors. This freezes the limitations or conditions on foreign investment on those that exist at the time the agreement comes into force. The idea behind this is to promote progressive liberalization and prevent “backsliding” from existing openness to foreign investors.

3.3 **Cooperation Only Provisions**

A number of agreements have included cooperation provisions for future possible liberalization, but no commitments relating to mandatory liberalization under the agreement itself. This is common, for example, in a number of the so-called EU-Euromed agreements between Europe and the North African Mediterranean states.

3.4 **Developing Linkages to Development Provisions in a Sequential Fashion**

A different option, and one more complicated in approach, is to tie any investment liberalization commitments to prior fulfillment of development assistance provisions in an agreement.

One common problem for developing countries in making any investment liberalization commitments is the ability to have the necessary legal and administrative structures are in place to be able to regulate the investments in a manner that contributes to the development of the host state. In addition, physical infrastructure may be needed in many circumstances. If a state wishes to make future commitments, it is possible to tie them to the fulfilment of certain development-focussed provisions that lay the groundwork for them to have a chance to be successful.

---

\(^7\) It may be noted here that there is no general international law obligation not to discriminate against foreign investors who wish to enter a country.
One option for negotiating these types of commitments, if ACP states should wish to make any, is to link them sequentially to capacity building and development commitments that ensure regulatory and administrative mechanisms are developed first with the necessary support. This would also ensure greater clarity concerning the expectations from foreign investors if investments in these sectors were to be liberalized.

This type of legal sequencing implies, at its root, a cooperative endeavour to promote development and investment in a manner that is most appropriate for the state receiving the investment.

3.5 A Non-binding List of Commitments (advertising approach)

A different option is to set out a non-binding list. In essence, this could be referred to as an “open for business” advertising mechanism. Under this approach, states may list areas where their domestic law on investment has been de-restricted, or where national treatment for investments is provided for. Unless accompanied by a ‘no-backsliding provision’, this approach in itself would not bind future government policy making. Future decisions to close a sector to more foreign investment or create other limitations could, therefore be available.8 This approach in fact has close parallels to a European-based trade and investment agreement in the energy sector, the Energy Charter Treaty.9

While continued switching between open and closed status cannot be a sound economic policy, leaving space for policy changes without having to negotiate them at a subsequent price (as in the GATS today if a state wishes to withdraw from a liberalization commitment) may be a reasonable approach to this issue.

Additionally, it must be noted that the removal of a sector from domestic liberalization should not impact upon the protections for investors that had entered that sector. Post-investment protections would not be affected by such a decision.

---

8 This approach has not been seen to our knowledge in a binding text to date. It has been employed in the IISD Model International Agreement on Investment for Sustainable Development (http://www.iisd.org/pdf/2005/investment_model_int_handbook.pdf), Article 3(E) Pre-establishment rights:
   i) Notwithstanding any other provision, nothing in this Agreement should be interpreted so as to create a right of establishment for potential investors in a potential home state.
   ii) Parties wishing to list sectors in which they have, under their domestic law, removed barriers to foreign investors, including in services sectors, may list these in Annex E to this Agreement. Any conditions or limitations on the right to establishment of foreign investors in the listed sectors shall be listed at the same time.
   iii) Investors in sectors listed in Annex E, or otherwise seeking to make an investment they have a legal right to make, shall, subject to the limitations or conditions also set out in Annex E or in domestic law, then be covered by the provisions of this Agreement for acts related to the establishment or acquisition of an investment.
   iv) States may amend their lists in Annex E, including any conditions, at their discretion, subject to the preservation of rights for an investor pursuant to this Agreement who has commenced the process of establishing an investment or who has established an investment.

9 The ECT allows states to list areas of energy-related investment where it has liberalized. What is not clear is whether the listing creates a permanent commitment. Clarity on this point is possible, however, in any other negotiation.
The current approaches to including investment liberalization commitments generally do not allow for any unilateral changes to be made. The major example, the GATS, requires states to negotiate alternative commitments if it wishes to make a change to a liberalized sector. This is based on the logic of progressive liberalization being a good thing at all times. Such a conclusion may not, in practice, be correct. Thus, another approach if liberalization commitments are undertaken is to allow unilateral changes to be made to a legally binding commitment by each party. This would create an enforceable commitment on pre-establishment rights, guaranteeing the covered investor access to that market, unless and until a Party made the necessary formal changes prescribed by the agreement to its list. The range of provisions described in section 2 above would continue to be used for this, except that a unilateral amendment process or the annexes would be allowed.

3.7 A Binding List with Provisions for Renegotiating or Approvals Procedures for Unilateral Changes

A further option is to include binding commitments with a preset renegotiation or amendment period. This could allow for unilateral changes during this preset window as well. Commitments would remain binding unless changed during this period.

3.8 A Provision for Temporary Safeguards Measures

A further option is to include a specific safeguards mechanism if the commitments on investment liberalization lead to unforeseen hardships in specific sectors. This would allow specific changes to any liberalization commitments to be made based on the criteria set out in the safeguards provisions. Such provisions usually have a pre-set time limitation. This has been used, for example, in the ASEAN regional agreement on investment.

Summary

In short, there are a multitude of avenues that can be considered by states in addressing the investment liberalization issues. There is no one consistent formula that is, in essence, required of developing states to be consistent with international law. What is clear however, is that if commitments are made, states must consider carefully what sectors should be included, which excluded, and what laws and regulations should be excluded from the commitments. This is a complex process, yet no shortcuts are available to do this right.

4. Expansion of Investor Obligations in Pre-Establishment Period

Making commitments on investment liberalization does not guarantee that such investments will come, nor does it guarantee that they will benefit the local economies. This latter aspect, in particular, raises the question of whether additional obligations should be written into an investment agreement in order to set minimum requirements for pre-establishment conduct by foreign investors.
To date, such an approach has been adopted by some developing countries in the pending negotiations between the African, Pacific and Caribbean states and the EU concerning Economic Partnership Agreements under the Cotonou Agreement. The negotiations are not yet complete, however, and thus the results not yet known. Draft negotiating positions of the developing countries including minimum standards for anti-corruption, and environmental and social impact assessment prior to the establishment of the investment.

5. Negotiation Strategy and Investment Liberalization

Including investment liberalization in an investment or trade agreement has traditionally been a response to the demands of developed countries. It is primarily market seeking for investors that come from markets where investment opportunities are often growing more limited due to market saturation. In other circumstances, and this now includes a number of more advanced economies from developing countries such as China and India, the demand arises due to the need for new investments to be made in lower cost production facilities or critical natural resources to maintain supplies of products or productions chains, including critical energy and mineral supplies. Thus, investment liberalization commitments can be understood as a demand from developed and relatively more developed countries.

The liberalization demand side of the negotiation can be seen at all negotiating levels: bilateral, regional and multilateral. At the bilateral level, it is now a common demand of the US, Canada and a growing number of developed countries. At the regional level, it has most recently surfaced in the inter-regional negotiations on Economic Partnership Agreement between the EU and its former African, Pacific and Caribbean colonies. It is also a feature, at least in principle, in the regional ASEAN agreement on investment.10

Investment liberalization was also a key issue in the WTO negotiations until July of 2004, when it was dropped from the current Doha Round. The penultimate act in that process reveals, however, a critical factor for developing countries in particular to consider before including investment liberalization within the scope of a negotiation. This is the potential connection between enhanced trade liberalization and market access for developing countries, and investment liberalization and market access for developed countries.

At the WTO Ministerial meeting in Cancun in September 2003, the penultimate draft of the Ministerial statement, which was never adopted, included a note that expressly sought to link investment liberalization negotiations by developing countries with market access in agriculture and non-agricultural goods for developing countries. In other words, developed countries tried to hold trade liberalization for the benefit of developing countries hostage to investment liberalization negotiations going forward. This effort ultimately failed.

10 The ASEAN investment agreement includes, in principle, extensive liberalization commitments to be fully implemented by 2010. In practice, however, to date the impact of these provisions has been limited by the use of extensive exceptions in annexes to the relevant agreements.
Whether conducted on a positive or negative list approach, the juxtaposition of trade liberalization against investment liberalization is a complicated and potentially lose-lose game for developing countries. Great care must be exercised to make sure that the result of such a mixing is in their best interest.