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The Right of States to Regulate and International Investment Law

Comment by

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1. Rethinking the Purpose of International Investment Agreements

In what has now become shorthand for a complex set of issues, the concept of “the right to regulate” is increasingly seen as a critical element to understand the development of international investment law and policy. One driver for this is the role of civil society in raising questions over the apparently growing loss of national sovereignty in the face of broader and deeper trade and investment obligations being generated at the international level. A second but closely related driver is the growing body of cases where public welfare legislation has been challenged under trade and investment agreements.

This comment begins with a challenge that goes to the very heart of the current debate on international investment agreements (IIAs) and the state right to regulate. The challenge can be phrased as a simple question that many believe must now be answered prior to further development of IIAs: should the objective of investment agreements be to protect foreign investment, or to promote and protect sustainable foreign investment?

Civil society groups have, with few exceptions, mobilized forcefully against more negotiations on IIAs as a result of the experience under NAFTA’s Chapter 11 on investment and the successful opposition to the negotiations of the Multilateral Agreement on Investment in the OECD. While this experience cannot be chronicled here, it suffices to say that both the substance and process associated with NAFTA have caused worry on issues such as the right to regulate and the transparency and suitability of the investor-state dispute resolution process that determines whether investor rights have been breached by the exercise of the right to regulate. The underlying rationale for this opposition is that IIAs have become a charter of rights for foreign investors, with no concomitant responsibilities or liabilities, no direct legal links to promoting development objectives, and no protection for the public welfare in the face of environmentally or socially destabilizing foreign investment.1

At the same time, a growing number of observers have demonstrated the need for FDI as an essential component of sustainable development strategies at the national and global

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1 This view was solidified for many civil society groups with the release of the Metalclad Corporation v. United Mexican States, Award, International Center for Settlement of Investment Disputes (Additional Facility), Case No. ARB (AF)/97/1, 30 August, 2000, where the Tribunal repeatedly refers to the investment promotion and protection purpose of NAFTA’s Chapter 11 in an environmental case of significant importance.
levels. Quite literally, hundreds of billions of dollars in investments are needed today if poverty alleviation and development opportunities are to be moved forward in the developing world. This is most obviously so for the least developed countries. In addition, hundreds of billions of dollars in FDI is needed if unsustainable natural resource management and industrial practices in developed and developing countries are to be turned into sustainable ones. Only by maximizing global investment opportunities can these two fulfill this requirement. Given this perspective, new thinking on the role of IIAs as a tool for promoting sustainable development – the only conceptual framework that links these two global economic requirements – is needed.

This comment seeks to provide a basic understanding of how the notion of the right to regulate fits into a reconstruction of IIAs as investment agreements for sustainable development.

2. **A Primary Consequence of This Change in Thinking for Addressing “The Right to Regulate”**

A primary consequence of proposing such a change in thinking is that the context for the policy issues under consideration at the Experts’ Meeting, as described in the Note by the UNCTAD Secretariat, may benefit from some revisiting. For example, the structure and direction for the paper seem to address just one half of the relationship between foreign investors and their host states and communities: the impact of the domestic setting on the investment. It pays much less attention to the dimension that is essential to address from a sustainable development perspective: the potential impact of foreign investments, especially FDI, on the local and host state economy, environment and social context.

It is important to state at the outset that the impact of foreign investments are not always, and is certainly not necessarily, negative. Quite the contrary. The very context of suggesting IIAs as agreements for sustainable development focuses the mind on achieving the positive results that are available from FDI. Doing so, however, requires a continuity in design that links all areas of investment promotion and management, rather than segregating specific issues in the context of the right to regulate.

For example, when discussing host country measures, the discussion paper focuses on promoting the local development relationships of FDI measures, but with no mention of local sustainable development relationships. This has several impacts. For example, it reduces or eliminates a potential focus on *institutional development within the host state* in areas such as environmental and labour management as part of the framework for attracting sustainable foreign investment, despite their critical relevance both to investors and to host states. It also reduces any discussion of the appropriate role of home countries, inside or outside IIAs, in supporting the development of these domestic legal regimes and institutions, or the potential to *supplement* host states laws in these areas with minimum standards of conduct for foreign investors.
Using IIAs to supplement domestic legal regimes may, at first blush, sound overly aggressive and controlling of foreign investors. It should not be. One must recognize that existing IIAs actually go well beyond supplementing one aspect of the legal and administrative infrastructure in host states: they create both choice of law and choice of forum rules that allow foreign investors to completely replace the host state laws on how they may be treated with international laws and remedies. There is no inherent reason why IIAs that already legally displace one aspect of host state laws cannot be used to supplement other areas when domestic regimes may not yet be sufficient to establish a longer term, sustainable investment infrastructure.2

In this vein, the concept of corporate social responsibility (CSR) is often raised as a way to supplement host state requirements on foreign investors. CSR is raised in the section of the discussion paper on home state policies. One can imagine the development of specific rules or codes and so on relating to CSR, as was considered in the dying stages of the OECD’s Multilateral Agreement on Investment negotiations. However, there are also opportunities, under a sustainable development concept for IIAs, to add additional links between home state policies and CSR. One such link is to require foreign investors to bring their home state laws “with them”. This approach is very controversial and may not be the most appropriate approach, at least not in all cases. However, it is possible to use IIAs to ensure general duties of care on foreign investors are legally applicable. In particular, rules in domestic courts that now limit or preclude headquarter companies from being forced to accept legal responsibility and liability for the acts of its foreign investments acts as a negative incentive for CSR today. An IIA that has sustainable development as its core value rather than simply the promotion or protection of all foreign investments could include a requirement for home states to undo any existing elements of rules, such as forum non conveniens, that continue to block judicial processes on liability.

The future development of IIAs should, it is submitted, consider the two directions of international law on foreign investment that are feeding the current civil society impression that international investment law is a system of corporate rights without responsibility or liability. While there is a growing right for a foreign investor to invest and repatriate all profits, there is only limited, and often no, liability placed on that same right-holder for how those profits are made. This perpetuates the sense of IIAs as part of a well organized corporate agenda disconnected from any negative impacts created by the beneficiaries of the rights they contain. An international agreement that eliminates the forum non conveniens rule will ensure that the right to make a profit is coupled with the liability for how that profit is made.3

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2 Basic elements can be envisaged here: mandatory environmental assessments for projects over a defined level, environmental management system requirements, emergency preparedness, public disclosure, and other well known and existing tools.
3 Some difficult legal issues would certainly arise here. For example, should liability be attributable only for the decisions of the foreign investor itself, or also of the investment abroad; how can these be distinguished in practice, etc. While there may be some difficult questions, these do not obviate the need to bring liability into the IIA framework.
There is also a link here to the right to regulate. Many of the states that are the primary host state “targets” for investment agreements have both weak domestic legal regimes and enforcement regimes. While enforcement of laws can only take place within the enacting state, civil liability regimes work to buttress the sense of compulsion for meeting all relevant standards and duties of care, including environmental and human rights responsibilities. Thus, ensuring that the liability for decisions is co-located with the right to make profits from foreign investments will help domestic law enforcement in host states as well.

3. Ensuring the Right to Regulate: Defining the Right Starting Point

The right to regulate discussion in the current context has two distinct elements:

- the right to regulate foreign investment to promote domestic development priorities and linkages; and
- the right to regulate to protect the public welfare from possible negative impacts, both individual and cumulative, of foreign and domestic investments equally.

Given the awareness of how recent agreements have unfolded in civil society and governments, both of these contexts are now critically important to the future of IIA negotiations.

The proper starting point for addressing the right to regulate in both these areas begins, it is submitted, with the simple proposition that the right to regulate is a basic attribute of sovereignty under international law. The right to regulate is not granted by trade and investment agreements. It is the restriction of the right to regulate that is at issue in this discussion, and a proper starting point would recognize that such restrictions ought to be applied as an exception to the general right to regulate, and only when it is demonstrably in the public interest to do so. A preamble that recognized this approach would reverse the current trends in trade law of seeing the right to regulate as an exception to be narrowly interpreted.

An additional factor in support of this starting point is the growing recognition, including in the WTO and the World Bank, that medium and long-term benefits of trade and investment liberalization can only be achieved in the context of appropriate and effective domestic regulatory environments. Given this recognition, constraints that prevent the development of regulatory measures impacting FDI, both pre- and post-establishment, can work to undermine what global economic institutions now recognize as essential to achieving both sustained and sustainable development. As a result, such constraints

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should presumably be limited, as already suggested, to when they are demonstrably in the public interest.\textsuperscript{5}

An example of this approach in action would relate to performance requirements. While there is increasing evidence that performance requirements such as domestic content in manufacturing carry few benefits and create significant risks of scaring off investors, there remains some evidence that they can, in certain cases, have development benefits.\textsuperscript{6} Thus, the issue can be framed as whether IIAs should ban all such measures or otherwise significantly discipline them, or whether the market provides a better vehicle for this while leaving states open to identify specific uses of performance requirements that may be beneficial to them. The approach suggested above would leave the market for inward investment as the primary vehicle for disciplining inappropriate performance requirements. It may be worth noting here that many regional trade agreements incorporate domestic content performance requirements in a backdoor manner through country of origin requirements that act as a pseudonym for local content requirements to be met before a product qualifies for beneficial tariff treatment within the regional market.

Other experts will focus on regulating for development purposes in the context of balancing foreign investor interests with domestic development policies and strategies. This includes issues like pre-establishment national and most favoured nation treatment and performance requirements. In the sections that follow, the main area of focus will be on the regulation of investors in the public interest. This is primarily understood today as post-investment regulation, but we shall also suggest areas of pre-establishment regulation that are quite relevant.

4. Considerations Relating to Current Trade and Investment Models on the Right to Regulate

The first point to make is that trade and investment are not the same thing. Trade may be an outcome of investments, and investments may be motivated by trade opportunities. In economic terms, there is clearly a close and increasingly complementary relationship between trade and investment decision-making. This close economic relationship, however, does not mean that the public welfare interest in trade and investment – and hence the need to establish rules as well as the character of those rules – will be the same.

Clearly, FDI is likely to have a far broader range of potential impacts on the host state and host community than the act of trading most products. Air and water emissions, water consumption in production processes, the types of technologies used and human resource relations in an industrial facility and community are among the many complex

\textsuperscript{5} There is considerable doubt, for example, in the capacity of most developing states to meet all the requirements of TRIPS, the TBT Agreement, the SPS Agreement, and other trade law requirements.
\textsuperscript{6} See, for example, the comments of Dr. Nagesh Kumar, “Use and Effectiveness of Performance requirements: What Can be Learnt from the Experience s of Developed and Developing Countries?”, at the UNCTAD Expert Meeting on the Development Dimension of FDI, 6-8 November 2002, Geneva.
factors directly related to the establishment and operation of an industrial or natural resource-based investment, whether foreign or domestic. For host states, these are fundamental matters directly and inextricably tied to ensuring that an appropriate and effective domestic regulatory regime is in place to ensure the benefits of foreign and domestic investments are achieved. They are not issues that can be disconnected from an investment, and therefore are not issues that ought to be disconnected from international investment regime building.

When the breadth of the investment relationship to the host state is considered, as opposed to just the host state relationship with the investor, it becomes clearer that a full reconsideration of the basic structure and purpose of existing IIAs is required to balance these two dimensions. This would properly anchor the rights of host states and communities in the international law relationship created by IIAs.

In the context of right to regulate issues, this suggests a strong need to recognize the inherent right to regulate as the starting point in an IIA. The preamble or a substantive paragraph can be used for this purpose. But such a recognition cannot come with the type of simple caveat found in NAFTA’s recognition of the right to regulate, “consistent with this Chapter”. This language acts not as a recognition of any inherent right, but as an expression of the primacy of the agreement and hence a limit to any right to regulate as the starting point in a legal analysis.

The different impacts of trade compared to investments also means that one cannot assume that the rules of one field can simply be transferred to the other. To do so risks a serious misappropriation of rules and related institutions. This is clear, for example, should anyone seek to transfer the analysis of “like products” in the WTO jurisprudence to a concept of “like circumstances” between domestic and foreign investments. The economic competition basis of the like products analysis yields a static assessment, while investments have a series of dynamic and ever developing relationships with host communities and states that vary from facility to facility and community to community. Local ecosystems, population concentrations, industrial concentrations, water tables, geographical impacts on air sheds, the capacity to meet possible environmental liabilities, differing production technologies, and other factors all defy any kind of simple test for assessing when investors are in like circumstances. National treatment and most-favoured nation rules against discrimination based solely on the origin of the investor will have a place in investment agreements. However, only a full assessment of the two sides of the investor and host state relationship – the impact of state acts on the investor and the impacts of the investment in the host state and community – can establish a context for

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7 See Article 1114 of the North American Free Trade Agreement.
8 Notably, this same language now appears in para. 6 of the 1991 Doha Ministerial Declaration of the WTO. It should be noted here that the environmental and human health exceptions generally applicable to NAFTA rules are not applicable to Chapter 11 on investment.
assessing an issue such as like circumstances. In addition, a balance between prohibitions against arbitrary and abusive discrimination and circumstances where origin may be a legitimate factor to take into account will also have to be set out.

A further general principle in setting out the right to regulate should be clarity. Trade and investment agreements have been strewn with general obligations that lack clarity and precision. National treatment, most-favoured nation treatment, minimum international standards and expropriation rules all reflect a broad language approach to drafting in current agreements. But this approach is one that has now begun to distort the role of IIAs by making them available as swords to fend off new laws and regulations. The lack of precision and clarity is being used by foreign investors to threaten arbitrations under IIAs as a response to proposed new rules, leading in many cases to a phenomenon of regulatory chill, the inability or fear of governments to take measures due to the unknown but potentially very expensive consequences of vague IIA rules. In this context it is critical to note that investment agreements are now mainstream legal tools that one can anticipate being used as often as possible. The era of “gentlemen barristers” employing IIAs as tools of last resort is, simply put, dead. Drafters of IIAs must now respond to this change with the clarity and precision needed to give governments security in their ability to act in the public interest.

The expropriation provisions in NAFTA’s Chapter 11 provide a cogent example of this. Starting from various international and American legal positions, lawyers have now argued on several occasions that environmental protection measures with a significant economic impact on a business amount to a expropriation. While these arguments have not yet won in any case, it is equally true that the decisions in each case where it has been raised leave room for continued arguments on these lines to be made, creating ongoing uncertainty for government lawyers and regulators.

5. The Missing Element: Investor-State Remedies and the Right to Regulate

Closely related to the substance of the right to regulate is the process for adjudicating whether the right has been breached. This issue is absent from the discussion paper, but is fundamentally important for three reasons. First, in balancing the government right to regulate with private rights, IIAs have moved well outside private matters into matters of significant public interest. In accordance with basic principles of justice in a democratic

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10 There is a growing debate about whether non-discrimination is now a principle of international law. In my view, this issue is not particularly relevant in the present context. What is clearly open for debate in the IIA context is the scope and application of any non-discrimination rules, just as they are continuously evolving in trade, human rights and other contexts.

11 The capacity of foreign companies to address environmental emergencies and large-scale liabilities following a major accident may, for example, lead to additional emergency preparedness requirements and legitimate requirements for posting of bonds or other assurances.

12 It is noteworthy that no compensation for clean air, water, hazardous waste management or similar legal measures has ever been paid in the United States, the purported source of the new and expanded international law interpretation on this issue.
context, such issues require public hearing in impartially chosen and open tribunals.\textsuperscript{13} The traditional investor-state process fails to meet these basic needs for adjudicating public welfare issues.

Second, the concept of sustainable development is increasingly understood as incorporating public rights of access to information and decision-making processes, and accountability of decision-making bodies. Again, the investor-state process fails on this account.

Third, public and civil society credibility of IIAs has been savaged by the secrecy of the investor-state process. To this day, it is impossible for the best of researchers to know how many cases relating to regulatory measures have been initiated. Hence, the full impact of these agreements on environmental and other aspects of human welfare protection cannot be measured. In addition, the occasions on which threats of uses of IIAs have been successful cannot be determined. This secrecy discredits the entire process in the eyes of civil society groups, and quite legitimately so. Given the growing connection of IIA rights and their use in relation to regulatory measures, this issue cannot be disconnected from the substantive analysis of the right to regulate.

6. Conclusion

In conclusion, it is submitted that a reshaping of the purpose of investment agreements from protecting foreign investors to creating investment agreements for sustainable development will provide a proper basis for protecting the inherent right of states to regulate in the public interest. This does not mean no disciplines would be available to protect against discriminatory or abusive uses of government power. However, such a rethinking would reverse current trends towards seeing the right to regulate as something granted under trade and investment agreements to be exercised only in limited and defined circumstances. The new direction would see the right to regulate as something inherent in the sovereignty of states and thus to be limited only in specific and clear circumstances.

Such restrictions can serve legitimate public purposes, especially as it relates to the good governance of all investors. A focus on IIAs as explicit instruments for sustainable development will ensure that identifying the public purpose for restrictions should be the first step in the process of enacting restrictions.

\textsuperscript{13} That investment cases now go beyond traditional private commercial matters to serious public policy and public welfare issues is recognized in \textit{Methanex Corporation v. United States of America}, Decision of the Tribunal on Petitions From Third Persons to Intervene as “Amici Curiae”, 15 January, 2001.