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Foreign Direct Investment : Its Impact on Human Development

This note describes a joint project of the CPDR (Centre for Legal Philosophy - UCL), the IIL (Institute of International Law – KULeuven : http://www.law.kuleuven.ac.be/iir/nl/), and LICOS (Centre for Transitional Economies – KULeuven : www.econ.kuleuven.be/licos/default.htm). This interdisciplinary project seeks to reflect on the liberalization of international investment, especially through the conclusion of bilateral investment treaties (BITs), and to put forward proposals which could ensure that such liberalization effectively contributes to the goals of human development centred on the realization of human rights. The inquiry is limited to private foreign direct investment (FDI) and does not include official development aid (ODA). Neither does it cover portfolio investment.

Defining the Framework[1]

An introductory study will examine the phenomenon of BITs (quantitative, geographical spread) and other agreements (regional free trade agreements esp.) which favor the liberalization of international investment and the actual flows of FDI (between developed countries and between developed and developing countries, evolution in time). This introductory study will comprise a description of the historical evolution of the legal instruments used to promote FDI, recalling e.g. the failed attempt to achieve a multilateral agreement on investment in the framework of the OECD and the debates this led to.

The introductory study will also describe the shift in development discourse (esp. within the UNDP) : from development conceived as economic growth and calculated on the basis of the growth of BNP or revenue per habitant to development conceived as the expansion of freedom ('human development') ; the shift shall be linked to a discussion of the obligations of States under international human rights treaties (obligation not only to respect, but also to protect and fulfil, which requires that the States have sufficient resources and allocate those resources to the needs of the population). It shall also reflect on the debate on the link between progress of liberalization of FDI and human development : on the basis of a review of the work performed within the OECD, the World Bank, and the United Nations (UNDP, UNCTAD, HCHR), the introductory study will identify the questions which are currently pending and which the project seeks to answer

Finally, the introductory study shall formulate the general question of the project : Considering the different tools through which FDI flows may be encouraged and the available studies on the impact of FDI inflows on human development, which reforms should be brought to the regulation of FDI inflows in order to maximize the contribution of FDI liberalization to development?

The Legal Framework[2]

This part will offer an overview of the legal framework on FDI flows. It will briefly describe the overall context, including the relevant provisions in multilateral (WTO TRIMs Agreement) and regional (NAFTA, Mercosur,…) agreements. It will however focus on the development of BITs and provide a detailed legal analysis of the provisions usually found in such treaties, such as :

- Scope and definition of foreign investment
- Admission and establishment
- National treatment in the post-establishment phase
- Most-favoured nation clause

[1] This part will be prepared within the Centre for Legal Philosophy (CPDR), Université catholique de Louvain, under the responsibility of Prof. Dr. O. De Schutter.
[2] This part will be prepared within the Instituut voor Internationaal Recht (Institute for International Law), Katholieke Universiteit Leuven, under the responsibility of Prof. Dr. J. Wouters.

- Fair and equitable treatment
- Guarantees of free transfers of funds and repatriation of capitals and profits
- Dispute settlement provisions (State-State and State-investor)

In addressing these clauses, this part will seek to identify an identifying customary law of international investment law, in the formation of which both the precedent of Chap. 11 of the NATFA and the 'Model BITs' such as the 2004 U.S. Model play an important role. This part should ideally conclude on the 'sovereignty costs' of BITs (i.e., the loss of regulatory autonomy for States concluding BITs) and on the conditions in which such BITs are being concluded, and dicuss the collective action problem facing States to which BITs are proposed when they are competing for scarce foreign investment. An answer to this latter question may lead to examine the respective advantages of a multilateral framework (such as the MAI in the context of the OECD) and of a bilateral framework (in classical BITs) for the negotiation of investment liberalization.

The Economic Analysis of Foreign Direct Investment[3]

This part of the research shall be based on a review of the existing literature in development economics, in order to answer two questions :

- **What are the determinants of FDI flows and, especially, to which extent does the existence of a BIT (or other – multilateral or regional – legal instruments seeking to protect the rights of investors) contribute to attracting foreign investment, and may this contribution be quantified in comparison to other factors ?** It may be presumed that such a contribution exists at different levels : BITs not only provide a legal framework ensuring that the foreign investor is recognized certain guarantees ; it also fulfils an important « signalling » function (the State concluding a BIT sending the message that it seeks to attract foreign investors and to create a climate hospitable to FDI) ; and it may be seen as part of a larger process of integration of a national economy into the global economy which includes, e.g., the development of a system of property rights and the establishment of the rule of law which foreign investors may see as a condition for their arrival.

- **To which extent do FDI inflows, especially when encouraged by BITs, contribute to human development in the receiving State ?** While it is clear that FDI inflows favor economic growth, the quality of this growth is variable : it may or not be fulfilling the needs of the population by the provision of public goods (health, education, infrastructures), it may or may not lead to transfers of technology or the formation of human capital in the local workforce, it may or may not crowd out local producers. Therefore it should be asked – beyond the measure of economic growth as such – what the existing economic studies on the impact of the opening of economies (esp. of developing countries) to FDI conclude with respect to its impact on 'human development' as defined in the introductory part of the study. In order to measure this impact, three distinctions should ideally be drawn in the literature review :

  1°) First, both **direct** and **indirect** impacts of the raise in FDI inflows should be included :

  - **Direct impacts** : pressure on the level of regulation, both negative (e.g. lowering of environmental and social standards) and positive (e.g. further investments in human capital, enhanced efficiency of local businesses)
  - **Indirect impacts** : fiscal revenues necessary to promote the right to health, to

[3] This part will be prepared within the Centre for Transitional Economies (LICOS), Katholieke Universiteit Leuven, under the responsibility of Prof. Dr. J. Swinnen.

education, etc. (e.g. export-processing zones)

2°) Moreover, the impacts of FDI should be distinguished according to whether FDI is being encouraged through **rules** (changes in the regulatory regime, including through the conclusion of BITs or other international agreements guaranteeing the rights of investors) or through **special incentives** which benefit only certain individual investors (for instance, tax holidays granted to certain investors, export-processing zones with lowered fiscal or regulatory requirements), as the latter may be competition distorting and represent fiscal losses for the receiving State. It would be crucial to identify whether the available economic literature makes a distinction between 'rules-based' and 'incentives-based' measures to attract investment, and in that distinction, where BITs (which only benefit the investors from the other State, and not all foreign investors) should be classified.

3°) Thirdly, BITs are only one among many other instruments which may be resorted to in order to attract FDI. Thus, it would be useful if the literature review could summarize the findings of existing studies of FDI inflows on human development by distinguishing general studies on this question and studies focusing on investment liberalization through BITs (that is, the impact of the conclusion of BITs on human develoment in FDI-receiving countries, controlling for other factors), even though this may be difficult to isolate adequately.

Policy Proposals[4]

This this part shall seek to map the different proposals which have been made in order to ensure that the growth of FDI flows effectively contributes to human development in the receiving countries. These policy proposals will distinguish between four categories of addressees (multilateral organisations, home States, host States, multinational enterprises) and relate the proposals to the international human rights framework and the obligations imposed under the international law of human rights on those different actors. The appreciation of the different proposals will depend on the results of parts I and II, as these parts should serve both to identify the potential dangers of the current approach to investment liberalizing measures, especially through the conclusion of BITs, and to verify whether the presuppositions guiding the adoption of such measures (in terms of their expected economic impacts) are well-founded.

It is suspected that the economic analysis of the impact of FDI (under the second question to be examined in that part of the research, as described hereabove) will lead to the conclusion that whether or not this impact is positive depends in large part on whether the receiving country provides for an enabling environment (for example, positive spillovers of FDI on the formation of human capital or on technology transfers requires that the gap between the technologies used by the investor and the local economy is not too important, so that local sub-contractors may benefit from such spillovers and absord new technologies). In principle, our policy proposals will not concern this dimension, but they will focus on the use of legal instruments seeking to encourage FDI. However, such tools, for instance the negotiation of BITs or accession to a regional trade agreement including a provision on investors' rights, may go hand in hand with certain initiatives, for instance the reinforcing of the institutional and regulatory framework and of the capacity of the host State to enforce that framework (reinforcing of labor inspection, for example). Moreover, the opening to FDI may be paired with the adoption of compensatory measures, for instance in order to attenuate any negative impacts of the arrival of FDI on the local producers. To the extent the creation of such 'enabling conditions' consist in the adoption of policy measures which the FDI receiving State may adopt when it chooses to open itself to foreign investment, and are not simply part of the general economic context in the receiving State, they may be part of the recommendations of the study. Indeed, such recommendations should be seen as defining the framework under which BITs in the future might be negotiated : the adoption by the host

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State of measures paralleling the opening to FDI which may be implemented in the short term may be part of this framework.

Among the policy proposals the desirability and feasibility of which this part of the study shall examine will be, inter alia and without a pretense to exhaustivity, the following :

<u>In the negotiation of BITs</u>

- human rights clauses in BITs
- obligations imposed on the foreign investor (respect for human rights or for norms such as the OECD Guidelines on Multinational Enterprises ; performance requirements ; linkages to local producers)
- human rights assessments of investment liberalizing measures, especially (ex ante) prior to the conclusion of BITs and (ex post) in order to evaluate the impact of BITs to allow for revisions
- Specific obligations where essential services (health, education, water, sanitation, energy, transport, communications) are being privatized
- Reform of dispute-settlement provisions of BITs in order to ensure that human rights may justify restrictions to the rights of investors and in order to avoid the « regulatory chill »

<u>In the negotiation of multilateral instruments liberalizing investment</u>

- Transitional arrangements for developing countries (protection of infant industries from foreign investments)
- Positive measures favoring LDCs

<u>In the negotiation of both bilateral and multilateral instruments</u>

- requirements of transparency and participation of civil society organisations, and democratic control of parliamentary assemblies