

# **An Investment Regime for the Americas: Challenges and Opportunities for Sustainability**

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## **1. Introduction**

Foreign investments have grown spectacularly since the mid-1980s. In fact, together with trade liberalization and the communications revolution, the fast expanding web of foreign investment is one of the major forces driving the global economy. Foreign investments include portfolio investments in stocks and other capital assets, banking activity with securities and other types of financial transactions. The main subject of this chapter, however, is foreign investments in the form of the ownership and management of businesses in a foreign country. This is referred to as foreign direct investment, or FDI.<sup>1</sup>

As FDI has grown, this form of capital movement has emerged to play a central role in the provision of international development capital for developing countries. Given the spectacular growth in quantity and relevance of FDI, it is important to understand the rationale, dynamic and implications of FDI flows and the international agreements that help facilitate these flows, including how they relate to the pursuit of sustainability.

Section 2 reviews global growth in FDI over the past decade, its growth and trends in Latin America and the Caribbean. As the Americas moves towards a hemispheric investment regime in the context of the Free Trade Area of the Americas (FTAA), new questions emerge such as how this process addresses the potential synergies and conflicts of the FDI-sustainability interplay.

In Section 3 we review the investment negotiations in the FTAA, paying particular attention to the mandate set for the negotiations in the 1998 San Jose Declaration. Does this mandate offer a sufficient public policy objective for the investment regime, allowing for FDI-sustainability considerations in particular?

Our discussion of this question is addressed in Section 4 through a two-track approach. One track highlights the analytical underpinnings of FDI-sustainability linkages. These underpinnings suggest that foreign investment can create both opportunities for, and negative impacts on, environmental quality depending in particular on the broader policy framework in place. The second track focuses on one concrete experience: the North American Free Trade Agreement (NAFTA)—a key reference for the current FTAA investment talks. Here, we argue that there are sufficient grounds for concern over the impact of NAFTA's investment disciplines on the ability of governments to create and maintain environmental laws and policies as a necessary part of the broader policy framework.

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<sup>1</sup> Traditionally foreign direct investment has been defined as an investment involving management control of a resident entity in one economy by an enterprise in another economy (UNCTAD 2000). International agreements protecting foreign investment apply, however, to a broader range of foreign capital investments.

We are not arguing that the hemispheric investment negotiations need to be boycotted. Instead, the goal of this paper is to (1) discuss why the FTAA investment regime needs to have a *broader scope* – beyond a one-dimensional objective of the protection of foreign investment, and (2) what *shortcomings of the NAFTA's investment model* need to be explicitly avoided.

In section 5 we advance our argument by underscoring the political economy of the trade and investment liberalization process. The FTAA process cannot afford to ignore the growing political opposition to trade and investment liberalization regimes that pay no explicit attention to other legitimate goals, such as environmental sustainability.

In section 6 we focus on concrete recommendations and suggest three avenues that the FTAA talks could use to meet the investment-sustainability challenge: a) inserting an explicit sustainability dimension into its mandate; b) creating language that explicitly redresses the unintended impacts of investment provisions on the government regulatory abilities; and c) creating formal mechanisms for transparency in the negotiation and dispute resolution processes.

We highlight in final remarks that the idea that trade and investment-led prosperity in the Americas will happen regardless of any sustainability considerations is misguided. The FTAA process has an opportunity to choose the right track and to avoid the recognized shortcomings from other investment models. Choosing a “business as usual” dynamic can only erode the already fragile support for moving the trade and investment agenda forward.

## **2. FDI and Why It is Important for the Americas**

In the 1990s, global capital flows experienced very pronounced shifts. While official development assistance flows continued to decline in real terms, private capital flows set new records for foreign direct investment, portfolio investment, and commercial bank lending. As policy reforms and technological change increase global competition, firms respond by expanding internationally and investing in newer technologies. Governments, aware of the importance of private investment, compete to attract FDI by deepening the liberalization and reform process—bilaterally, regionally, multilaterally. This reinforcing dynamic is leading FDI to record levels of \$865 billion in 1999 (see Table 1) and an estimated \$1 trillion in 2000 (Thomsen 2000; UNCTAD 2000).

The liberalization of investment frameworks has involved three core objectives: *reducing restrictions* to foreign investors (such as barriers to entry); *strengthening standards of treatment* (such as non-discrimination, national treatment or recourse to international means for the settlement of investment disputes); and *strengthening market supervision* that ensures proper functioning of the market (such as competition policies, disclosure of information) (UNCTAD 1998). As we will see in the next sections the investment liberalization in the Americas clearly involves these three components.

Given long-time commitments of the investment horizon, FDI is generally the most stable of the private capital flows. This stability makes it particularly attractive to developing countries, which can then reap the additional benefits of better access to world markets, technology, and know-how. Additionally, the establishment of FDI-driven export processing serving local and regional markets directly is creating a distinct investment-trade liberalization nexus (O'Connor 2000; Thomsen 2000; Gentry 1998).

In aggregate terms, developing countries have successfully attracted FDI inflows in the 1990s, reaching \$207 billion in 1999 (compared to an annual average of \$46 billion in the 1988-1993 period). In terms of the global distribution of FDI flows, developing countries still lag behind developed countries. A striking example is that the United States alone receives more FDI flows (34.7 per cent) than the entire developing world (24 per cent) (See Table 1).

The concentration of FDI also occurs within developing countries, where three quarters of the inflows go to only eleven economies.<sup>2</sup> From the inflows in the developing world, Asia and Latin America receive about one half and one third respectively, while Africa receives less than five per cent. Consequently, some regions are being left further behind in development opportunities, as are many countries within the regions that are attracting the highest levels of FDI.

**Table 1**  
**FDI Flows by host region (1998-1999) -Selected Years-**  
(Millions of dollars)

Host region	1988-93 (Annual Average)		1995		1997		1999	
		<i>% of total</i>		<i>% of total</i>		<i>% of total</i>		<i>% of total</i>
<b>Developed countries</b>	<b>140,088</b>	<b>73.5</b>	<b>205,693</b>	<b>62.0</b>	<b>275,229</b>	<b>58.2</b>	<b>636,449</b>	<b>73.5</b>
European Union	78,511	41.2	114,387	34.5	128,574	27.2	305,058	35.2
United States	44,781	23.5	128,574	38.7	105,488	22.3	300,594	34.7
<b>Developing Countries</b>	<b>46,919</b>	<b>24.6</b>	<b>111,884</b>	<b>33.7</b>	<b>178,789</b>	<b>37.8</b>	<b>207,619</b>	<b>24.0</b>
Africa	3,472	1.8	4,699	1.4	6,896	1.5	8,949	1.0
LAC	32,816	17.2	32,816	9.9	69,172	14.6	90,485	10.5
Developing Europe	221	0.1	483	0.1	1020	0.2	2,315	0.3
Asia	29,854	15.7	73,324	22.1	101,575	21.5	105,621	12.2
The Pacific	236	0.1	563	0.2	126	0.03	248	0.03
<b>Central Eastern Europe</b>	<b>3,623</b>	<b>1.9</b>	<b>14,267</b>	<b>4.3</b>	<b>19,034</b>	<b>4.0</b>	<b>21,420</b>	<b>2.5</b>
<b>WORLD</b>	<b>190,629</b>		<b>331,844</b>		<b>473,052</b>		<b>865,487</b>	

Source: UNCTAD, 2000.

Another trend that has become increasingly important over the course of the 1980s-1990s is the emergence of mergers and acquisitions (M&As) as the prime vehicle behind the increase in FDI.<sup>3</sup> The consequences of FDI through M&As—as opposed to greenfield

<sup>2</sup> These countries are Argentina, Brazil, Mexico, Saudi Arabia, China, Indonesia, Malaysia, Singapore, Thailand, and Hong Kong, China (Thomsen 2000).

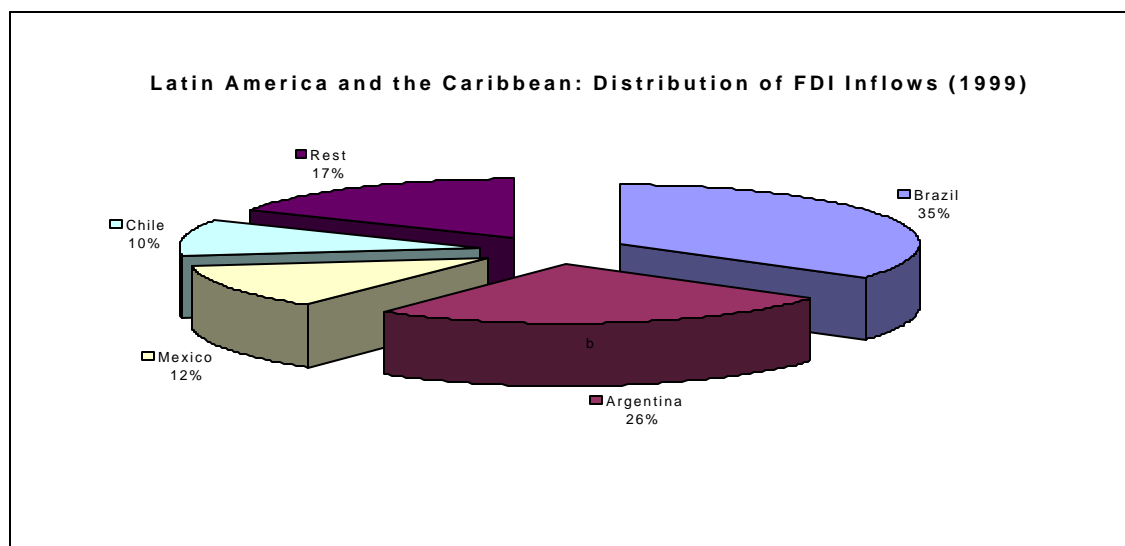
<sup>3</sup> The most visible and traditional form of FDI has been investment in new facilities—greenfield investment—which contributes new jobs and opportunities to the host economy. The other form, merger and acquisitions (M&As) involve merging with or acquiring an existing local firm, which usually are owned privately or by the state. Although conceptually FDI and M&As are easily discernible, available statistics make their distinction nearly impossible to apply. It is difficult to estimate precisely what share of FDI flows is accounted for by cross-border M&As because their values are fully not comparable (UNCTAD 2000).

investment—are not fully understood, and will not be explored here. However, we recognize this is an important issue that deserves further analysis.<sup>4</sup>

## 2.1 Key FDI trends in Latin America and the Caribbean

The trends accompanying global FDI flows are observed in Latin America and the Caribbean (LAC). In the 1990s most of the countries in LAC undertook sweeping reforms including macroeconomic stabilization, trade liberalization, privatization, and deregulation of policies on private investment. Combined with regional integration initiatives, a propitious climate for foreign investment emerged. As a result, FDI flows to the region increased substantially, reaching a new record level of \$90 billion in 1999. This represents approximately 10 per cent of the global FDI flows. However, as Figure 1 shows, the uneven distribution of the flows is striking: more than 80 per cent of all FDI inflows into LAC is concentrated in only four economies, Brazil, Mexico, Argentina, and Chile<sup>5</sup> (UNCTAD 2000; OECD 2000).

Figure 1



Source : UNCTAD (2000).

A comprehensive analysis of the drivers and sectors of the FDI growth into LAC will not be undertaken here.<sup>6</sup> But it is important to highlight that privatization programs are a leading influence on the growth of FDI in the 1990s, led by sectors such as telecommunications and energy.<sup>7</sup> Second, investments targeting the services sector have increased substantially as opposed to those in manufacturing. Third, as in the international landscape, a significant part of the FDI flows to the region (between \$41 and \$37 billion in 1999) is coming through

<sup>4</sup> The last report from UNCTAD (2000) explicitly addresses this issue (see Chapter VI).

<sup>5</sup> This trend is not new, since the 1970s these economies have been constantly receiving over 70 per cent of the total inward FDI in LAC (OECD 2000).

<sup>6</sup> See ECLAC (2000) for details and case studies.

<sup>7</sup> For example, Argentina, Chile, and Mexico's inward FDI flows grew largely because of their privatization programs in the mid-1990s. More recently, in the latter part of the 1990s FDI inflows to Brazil increased substantially as a result of the sell-off of publicly owned entities. Over a third of the investment in the telecommunications and electricity industries was generated by privatization.

M&As investments. While the United States is by far the largest investor in the region, Spain's growing share is noteworthy – especially in the Southern Cone Common Market (MERCOSUR) and Chile, but also in several Andean countries.<sup>8</sup> (ECLAC 2000; OECD 2000; UNCTAD 2000).

A growing investment-trade nexus is also observed in the region. There seems to be empirical evidence that regional trade agreements such as the North American Free Trade Agreement (NAFTA) and MERCOSUR have played a role in attracting FDI (UNCTAD 1998). This nexus is particularly evident in the NAFTA context where not only U.S.-based transnational corporations (TNCs) but also those based in Europe and Asia invest in Mexico in order to benefit from NAFTA's rules of origin for products (UNCTAD 2000).

By the end of the 1990's, TNCs had strong presence in LAC. As Table 2 shows, the number of foreign corporations in the list of the 500 largest companies<sup>9</sup> in LAC went from 142 to 202 and their share of total sales rose from 26.6 per cent to 38.7 per cent over the 1990's (See Table 2).

**Table 2**  
**Latin America and the Caribbean: Top 500 Companies**  
**1990-1992 and 1998**  
(Millions of dollars and percentages)

	1990-1992	%	1998	%
<b>1. Number of firms</b>	<b>500</b>		<b>500</b>	
Foreign	142	28.4	202	40.4
Private local	265	53.0	258	51.6
State	93	18.0	40	8.6
<b>2. Sales (millions of dollars)</b>	<b>360 142</b>		<b>646 351</b>	
Foreign	95 764	26.6	250 049	38.7
Private local	138 352	38.0	272 914	42.2
State	126 026	35.3	123 388	19.1
<b>3. Breakdown by sector (%)</b>	<b>100.0</b>		<b>100.0</b>	
Primary	27.8		17.4	
Manufacturing	42.2		41.4	
Services	30.0		41.2	

Source: ECLAC (2000).

Local private firms in the top 500 companies decreased slightly from 265 to 258 in the same period, although their share in the total sales increased. Manufacturing companies have maintained their dominance, generating nearly 42 per cent of the top 500's sales,<sup>10</sup> but services are the most dynamic sector, climbing from 30 per cent to 41.2 per cent in 1998 of the sales. Foreign firms' export performance is noteworthy. From 1995 to 1998 the number of foreign companies among the region's 200 largest exporters went from 66 to 95

<sup>8</sup> Spain was part of a landmark deal in the region when its largest company Repsol invested \$13.2 billion in 1999 in *Yacimientos Petroleros Fiscales* (YPF) of Argentina, placing the latter as the most second important Latin American recipient of FDI that year and sending Mexico to the third place. Since 1996, Spain has overtaken the United Kingdom as main European investor in the region, almost exclusively in the services sector. (ECLAC 2000).

<sup>9</sup> The list is based on net sales (pre-tax).

<sup>10</sup> In terms of the impact of foreign companies on Latin American exports, a central factor has been the automotive industry, which has accounted for approximately half of the manufacturing sector's exports. From the 100 largest in the *manufacturing sector*, transnational corporations increased their share of sales from 55 per cent to almost 61 per cent between 1995 and 1998 (ECLAC 2000).



companies and from approximately 30.6 per cent to 45 per cent of the total value of the sales of this group. These numbers reflect a 50 per cent growth in export shares for foreign owned companies. Over the same period, the number of private local firms dropped from 120 to 97, although these firms maintained their share of the value of exports at around 33 per cent (ECLAC 2000). The trends show an increased role of FDI as a real driver of increased wealth through increased manufacturing and export capacity.

Clearly, a systematic trend of increased transnational activity in the region and the concentration of many of them in a very reduced number of countries will lead to sustainability concerns. A concentration of foreign firms mainly in 3 or 4 countries can have scale impacts even if these companies use leading edge environmental technologies in a given facility. (See the discussion in section 4.1 below on this issue) Monitoring and mitigating this impact as much as possible will be an increasing challenge for local policymakers.

The investment negotiations in the context of a Free Trade Area of the Americas (FTAA) offer a clear opportunity for facing these policy and institutional challenges on a collective basis. But, is the FTAA process up to this task? The next sections focus on this question showing that a narrow focus on investors and investment protection practically leaves other goals at a disadvantage.

### **3. The FTAA Investment Negotiations**

The Free Trade Area of the Americas (FTAA) process was initiated in the 1994 Summit of the Americas to integrate the economies of the Western Hemisphere into a single free trade arrangement by 2005.<sup>11</sup> From 1995 until 1998 the process went through a preparatory stage. More than 50 technical meetings occurred among 12 hemispheric working groups. Notably, this process led to an active interaction and increased communication flows among governments never seen before in the region. Additionally, a Tripartite Committee was established to provide technical support to the FTAA process through technical assistance to the trade officers.<sup>12</sup> The negotiations are scheduled to conclude no later than the year 2005. More recently, Chile and the United States have proposed a 2003 deadline. The Andean and the Caribbean community have rejected these proposals (*Inside U.S. Trade*, "FTAA Vice Ministers Fail to Agree on Negotiating Timeframes" Feb.2, 2001).

The principles and objectives for the FTAA negotiations were laid out in the 1998 Declaration of San José, which served as the basis for launching negotiations in Santiago, Chile in April 1998.<sup>13</sup> The main principles, which apply to all negotiating groups and issues, included consensus-based decisions, single-undertaking, transparency, WTO-consistency, coexistence with other bilateral and sub-regional agreements, individual or group negotiation, and attention to the needs, conditions, and opportunities of the smaller economies. Nine Negotiation Groups, one of which addresses investment, were established and have met on a systematic basis since 1998.<sup>14</sup>

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<sup>11</sup> A chronology of the FTAA process is found at < [http://www.ftaa-alca.org/chronos\\_e.asp](http://www.ftaa-alca.org/chronos_e.asp) > (Official FTAA homepage)

<sup>12</sup> This Committee is formed by the Organization of American States (OAS), the Inter-American Development Bank (IDB), and the Economic Commission for Latin American and the Caribbean (ECLAC). This Committee has facilitated the preparation and negotiation process through the provision of publications and studies

<sup>13</sup> Text available at < [http://www.ftaa-alca.org/ministerials/costa\\_e.asp](http://www.ftaa-alca.org/ministerials/costa_e.asp) >

<sup>14</sup> The other eight are Market Access; Services; Government Procurement; Dispute Settlement; Agriculture; Intellectual Property Rights; Subsidies; Antidumping and Countervailing Duties; and Competition Policy. Since November 1999 until April 2001 Argentina is the chair of the process.

With foreign investment emerging as a critical driver for development (especially as official development aid's relative weight decreases) and with a growing international trend towards higher standards for investment protections, it was foreseeable that investment would be a core element of FTAA architecture. One must recall here that many aspects of the FTAA project were envisioned in the halcyon days of the post Uruguay Round Agreement of 1994, and prior to the debacle of the Multilateral Agreement of Investment (MAI) in October 1998.

In fact, despite the lukewarm attitude toward the inclusion of a multilateral investment regime in the World Trade Organization that prevails in a number of countries (e.g. the Ministerial Meetings in Singapore, 1999 and in Seattle, 1999), the FTAA proponents have not encountered such an attitude to date. Indeed, the prospects for making progress on the trade-investment interface appear so far to be better in the Western Hemisphere than in most of the other regional or institutional settings<sup>15</sup>

### **3.1 The Investment Negotiations to Date**

The FTAA investment negotiating group met nine times from its inception in April, 1998, to November 2000, its final meeting prior to the III Summit of the Americas (Quebec City, April, 2001). Although the final submissions of the negotiating group to the Trade Negotiations Committee (composed by the Vice-Ministers of Trade) were completed, they had not been made public prior to the completion of this paper.<sup>16</sup>

Background reports about the FTAA investment negotiations suggest that the main players in the investment talks to date are the United States, Canada, MERCOSUR, Chile, and Mexico. To date, the negotiators have engaged in a process that could better be described as a discussion of the different positions, as opposed to an actual negotiation of their differences.

Despite the absence of complete or up-to-date information, some idea of the scope of the current work can be gleaned from the official releases of the FTAA Investment Group.<sup>17</sup> These releases, which follow the conclusion of each negotiating session, indicate the range of issues actually being considered. Three clusters each have been considered to date and they appear to represent the intended scope of the negotiations:

- Cluster 1: Basic definitions, national treatment, most favored nation treatment, fair and equitable treatment;
- Cluster 2: Scope of application, key personnel, transfers, performance requirements; and
- Cluster 3: Expropriation and compensation, compensation for losses, general exceptions and reservations, and dispute settlement.

The full content and scope of the positions on these clusters are not yet public. To date, only the United States has publicly indicated its negotiating goals and concerns on this issue, but has provided little in the way of detail. One can glean, however, that the United States is concerned about the unintended impacts of the language adopted in NAFTA's investment provisions, as well as the public concerns with the secretive nature of much of the associated

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<sup>15</sup> In fact, Sauve (2000: 84) argues that, in the face of the ongoing doubts as to the appropriateness for its inclusion in other global fora, "the FTAA countries can do much to reenergize the sagging spirit of trade and investment liberalization that has taken root in many quarters of the world."

<sup>16</sup> The draft of the investment negotiating text was released after the

<sup>17</sup> The press releases are available on the official website of the FTAA process, at <[www.ftaa-alca.org/ngroups/press](http://www.ftaa-alca.org/ngroups/press)>.

investor-state dispute settlement mechanism, but no specific proposal has been submitted to the FTAA on investor-state provisions.<sup>18</sup>

Although Canada has also placed its FTAA negotiating statements on a web site, these do not contain any statements on the investment negotiations. Only sporadic statements of concern made by the Minister for International Trade over the current text of Chapter 11 of NAFTA can serve as a guide to Canadian intentions, but these are too imprecise to afford a basis for any detailed comment.<sup>19</sup>

Among Latin American countries, Chile appears to be willing to address some of the concerns about the NAFTA's investment provisions, while Mexico apparently stands behind them as the appropriate model for the FTAA. However, the arrival of the new Mexican administration might lead to changes in this position.

On the investment-environment front, reports from the press confirm that the U.S. has met strong opposition to proposals that governments be prohibited from relaxing environmental and labor standards in order to attract investment, and provisions that would require an environmental impact study for projects of a certain size (*Inside U.S. Trade*, "FTAA Vice Ministers Fail to Agree on Negotiating Timeframes" Feb.2, 2001).

Overall, observers are left with little in the way of concrete information on which to draw at this point in time. What is known is that the issue clusters represent the traditional scope of investment provisions, as modeled on NAFTA's Chapter 11 on Investment and bilateral investment treaties. There appears to be no "thinking outside the box" at the present time. Specific provisions have yet to be negotiated however, leaving open the possibility of alternative approaches in broader terms and more specific recommendations in relation to the existing issue clusters.

### **3.2 The Investment Mandate**

What is known at present is the basic mandate for the investment negotiations, which was set out in the 1998 Declaration of San José. This mandate calls on the negotiators to:

"establish a fair and transparent legal framework to promote investment through the creation of a stable and predictable environment that protects the investor, his investment and related flows, without creating obstacles to investment from outside the hemisphere."<sup>20</sup>

Clearly, this is a one-dimensional objective. It focuses on promoting investment by generating provisions that will protect the investor. This focus on investment stability and predictability leaves out of the scope potentially important considerations such as the sustainability of the FDI and the need for better distribution of the flows.

The rationale behind this limited scope for the investment talks is that attracting and maintaining FDI requires a reduction in investors' risk through a predictable legal framework and a stable macroeconomic and institutional environment. The availability of natural and human resources are also factors in any investment decision, but they are not necessarily sufficient for such a decision (UNCTAD 1998). Despite the existence of many bilateral

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<sup>18</sup> "Negotiating Group on Investment", Public Summary of U.S. Position, USTR, available in the USTR web site < <http://www.ustr.gov/regions/whemisphere/ftaa.shtml>>.

<sup>19</sup> See the departmental website at <<http://www.dfait-maeci.gc.ca/trade/menu-e.asp>>.

<sup>20</sup> See note 13.

investment treaties in the Americas, the added presence of a hemispheric-wide agreement, strengthening for example the right to arbitration procedures between a foreign investor and the host state, is expected to offer a powerful incentive for attracting new foreign investment to the region.

This is not the place to try to establish the actual impact of the regimes on investment choices. Rather, what we underscore is that, among other business factors, risk reduction is a major element in corporate decision-making. But how do the efforts to ensure full protection of investors and their investments impact other policy realms, such as environmental and health policy. Can something be done within the scope of an FTAA investment agreement to address such impacts? Shouldn't the FTAA process address explicitly the impact of its narrow focus on investment protection on the prospects for sustainability? It is to this investment-sustainability issue that we now turn.

## **4. Investment and Sustainability: A Two-Track Discussion**

Understanding why the mandate of the FTAA negotiations on investment is insufficient to promote sustainability leads to a two-track discussion. The first one relates to the investment and sustainability interaction. As section 4.1 highlights there are a number of factors that can make foreign investment become a driver *for* or *against* sustainability.

The second discussion concerns the need to address potential negative legal impacts that can emerge from the provisions and language of the investment agreements themselves. These legal impacts can limit the ability of governments to counterbalance the negative impacts of FDI. NAFTA is a case in point. In section 4.2 we focus on the investment provisions from NAFTA's Chapter 11 and their impacts on the government's ability to promote higher levels of protection of the environment and public health.

### **4.1 The Investment-Sustainability Interplay**

The role of FDI in achieving or obstructing sustainability is not yet fully understood. However, there is strong case to be made about the central role of FDI in any sustainable development strategy (von Moltke, 2000; French 1998; Schmidheiny and Gentry 1997). FDI provides much-needed infrastructure development, technology transfers, and capacity building such as technological, management and environmental training in the state that receives the investment.

There is some evidence that improvements in environmental performance can also accompany capital flows, through the introduction of new investment funds and management. In some documented cases, foreign companies bring with them more modern, cleaner technologies, proactive environmental management systems, and environmental training programs. They can create a local market for people trained in environmental issues and for suppliers of environmental services and equipment (i.e. waste treatment facilities). Annex 1 offers a concise conceptual framework on the FDI-Environment interplay. The analysis of the statistical and case study evidence suggest at least three conclusions about the investment-sustainability interplay (Zarsky 1999).<sup>21</sup>

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<sup>21</sup> Zarsky (1999) in her detailed discussion also finds that the evidence is still poor compared to the research needs. Additionally, she offers a very useful conceptual framework for FDI-environmental linkages.

- *No conclusion “on the average”*: There is no overarching conclusion yet regarding the balance of environmental sustainability benefits and risks posed by FDI flows. There are negative, positive, and neutral effects and the outcome is context dependent.
- *No race to the bottom, but no race to the top*: The wide concern among developing countries to be attractive to foreign investors in a highly competitive global economy has kept a lid on local/national environmental standards and on the enforcement of standards. There has not been universal “race to the bottom,” but as globalization deepens and in the absence of a global regulatory framework a “race to the top” has become more difficult to achieve, causing environmental commitments to be “stuck in the mud.”
- *Pollution Zones*: While “pollution havens” cannot be proven, a certain pattern of agglomeration of pollution is discernible, one not based in the difference in national standards, but on difference in the income/or education of local communities.

In some cases there can be effects on the scale of the environmental impact, regardless of the incremental improvements in individual company performance. All of these considerations lead to one important conclusion: effective regulation is still necessary to achieve good micro and macro environmental performance. In order to maximize the opportunities created by investment and trade liberalization, it is necessary to support and maintain optimal environmental management framework and capacity to ensure one-generation economic gains are not wiped out by next generation environmental costs or dislocations. While this concern certainly applies to all investment and not just to *foreign* investment, the negotiation of an international foreign investment regime, whose goal is to significantly increase the role of foreign investors in development and economic growth by providing special protections to the investors, presents a critical opportunity to address the associated need for ensuring an optimal environmental management framework and the capacity to implement it..

In fact, empirical studies from leading economic institutions such as the World Bank, or the World Trade Organization (WTO), show that in the absence of good environmental management, economic liberalization can have negative impacts on the environment. (Fredriksson 1999; Nordström and Vaughan 1999). In other words, “economic growth is not sufficient for turning environmental degradation around” (Nordström and Vaughan 1999: 6) and, therefore, not all kinds of growth are benign for, or supportive of, sustainability. A more recent and comprehensive study from the World Bank (Vinod et al., 2000) highlights that even though the *pace* of economic growth remains important its *quality* is more critical. Case studies show that four core dimensions seem to make the difference in the *quality* of development: a) the distribution of opportunities, b) the sustainability of the environment; c) the variability of global risks, and d) the framework of governance.<sup>22</sup>

Unfortunately, the one-dimensional economic focus reflected in the objective of the FTAA investment negotiations seems too narrow to capture the essential qualitative dimension of a successful economic growth strategy. Despite the great opportunities for sustainability in the Americas created by FDI,<sup>23</sup> increasing FDI flows, by itself, will not be sufficient to increase the quality of development in the Americas. Section 6 below provides some precise recommendations in this regard.

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<sup>22</sup> The conclusions are consistent with an OECD report (1999) which also highlights the role of policy coherence (i.e. strong social safety-nets, strong investment in human capital, and good governance) as part of a development strategy underscoring that trade and investment opening is a necessary condition for developing countries to grow and reduce poverty, but *by no means* a sufficient one.

<sup>23</sup> For specific examples in the Latin American context see the case studies of Costa Rica, Brazil, Mexico in Gentry (1998).

But, it is also fair to mention that this narrow scope is not a problem of the FTAA's investment chapter in particular. In general, investment agreements have consistently had one-dimensional goals. They lack an explicit dimension regarding their broader public purpose, thereby failing to strike a balance between the need to increase investment flows and the need to improve their quality and to diversify their distribution. From a legal perspective, by focusing on protecting investors and their investments they fail to match their rights with any minimum obligations. NAFTA's investment model offers important lessons in this regard, lessons which are relevant to this paper because it is precisely the model that seems to have most of the *gravitas* in the FTAA context.

## **4.2 Investment Provisions and the Government's Role in Protecting the Environment: NAFTA's Lessons**

Can investments provisions to protect foreign investment work against sustainability, perhaps inadvertently, by unduly constraining the ability of governments to protect the environment? Up until the end of the 1990's, there is no track record of bilateral investment treaties (BIT's) being used to lobby against the making of environmental or human health protection laws, or to seek compensation for the adoption of such laws.<sup>24</sup> However, the experience under NAFTA's Chapter 11 on Investment suggests a growing use of its provisions for both these purposes (Mann 2000; Mann and von Moltke 1999).

At least two important reasons can be suggested for this development. First, Chapter 11 has a broader combination of rights and remedies when compared to at least most BITs. (Horlick and Marti, 1997) This is part of a trend raising the levels of investor protections as investment agreements have evolved. Second, and equally important, is the historical change in the use of investment agreements from a shield into a sword. Investment agreements were originally designed as protection, or shields, for foreign investors. In a period when governments were actively nationalizing or expropriating businesses, and political instability was often accompanied by legal instability or legal systems wholly controlled by government officials, these agreements provided an avenue for protection against discriminatory and nefarious host government activity. They were originally designed to be recourses of *last resort*, beginning first with state-state recourses only, moving later to investor-state recourses on an agreed basis and often after the exhaustion of local legal remedies, and only in the 1990s to a mandatory investor-state arbitration process in place of local remedies (Sacerdotti 1997; Comeaux and Kinsella 1997). Under NAFTA, however, Chapter 11 has become a "sword", a tool of almost first choice in lobbying against regulations or new laws and in seeking redress for any measures taken by a government that impact on the profitability of a business (Rugman et al. 1999).

The shortcomings of these investment provisions—most probably unintended—were first highlighted by environmental advocates. However, more recently front-line trade liberalization proponents have also recognized that these concerns have merit (Hufbauer et al 2000; Graham 2000). While environmentalists and trade proponents may differ on the extent of the problems (and few efforts to actually consider them in a cooperative manner have been made), the explicit recognition of the existence of the problems by an increasing

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<sup>24</sup> This history may be poised to change. *Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States* (Case No. ARB(AF)00/02, International Centre for the Settlement of Investment Disputes (Additional Facility)), initiated by a Spanish investor against Mexico in September, 2000, appears to have at least some of the same underlying legal issues as seen in the Metalclad case discussed below under Chapter 11. It is to be anticipated that the trend seen in NAFTA investor-state litigation will be tested in the bilateral context, and this new case may provide a harbinger of such a shift.

number of observers from both groups ought to send a strong message to the FTAA negotiators that the shortcomings with the existing language are real.

What then is the scope of these problems from an environmental management perspective? Given developments in the jurisprudence since 1998, it is reasonable to suggest five specific issues that require careful consideration by FTAA negotiators:<sup>25</sup>

- a) Identifying the purpose of the investment provisions as a basis for specific legal interpretations and directions;
- b) The National Treatment and Most Favoured Nation disciplines;
- c) Minimum international standards;
- d) Performance requirements prohibitions; and
- e) Expropriation.

Each of these will be considered in turn.

*a) Identifying the purpose of the investment provisions as a basis for specific legal interpretations and directions*

Under the basic rules of interpretation of international agreements, arbitration Tribunals called upon to interpret provisions will look to the declared objectives and purposes of an agreement in interpreting specific provisions. This is normal and appropriate, and has been seen in some key decisions of arbitral bodies under Chapter 11 (See Annex 2 for a summary of the cases that are related to environmental issues). In most cases, these objectives and purposes are to be found in one of two parts of an agreement, the preamble, or an objectives or purposes article. Their use as an interpretational touchstone provides an important additional reason to carefully consider the implications of a one-dimensional objective to investment provisions. The dispute *Metalclad Corporation v. Mexico* (or *Metalclad*) illustrates this point well.<sup>26</sup>

In the arbitral decision in *Metalclad*, the Tribunal referred expressly to the objectives it believed were relevant to interpreting the provisions of Chapter 11. One may readily note that the Tribunal referred to only three NAFTA objectives as underpinnings for the interpretation of Chapter 11:

- Transparency in government regulations and activity (paragraph 70-71);
- The substantial increase in investment opportunities (paragraph 70, 75); and
- To ensure a predictable commercial framework for investors (paragraph 71)

In addition, the Tribunal added an interpretational spin to these objectives, arguing that it was the goal of NAFTA and hence of Chapter 11 to ensure the successful implementation of investment initiatives (paragraph 75).

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<sup>25</sup> Our goal here is not to provide an exhaustive legal review of each issue, but rather to highlight the key issues in summary form and suggest an appropriate path for addressing these issues in the negotiating process. Case citations are to the main decision in each case, unless otherwise noted, which are listed in the references. A comprehensive data base of all NAFTA Chapter 11 decisions can be found on-line at <<http://www.naftalaw.org>> Much of this section is has been explained in detail in Mann and von Moltke (1999). This section however has new elements supplemented by the cases decided over the course of the year 2000.

<sup>26</sup> This dispute involved the US-based Metalclad Corporation (petitioner) and the Government of Mexico. The subject of the dispute were the actions by the Mexican government preventing the opening of a hazardous waste landfill. The tribunal ordered Mexico in August 2000 to pay Metalclad \$16.7 million in damages to the investors.

Clearly, identifying only such investor-focused objectives in a complex environmental case creates a high risk of an imbalance in the interpretation to be applied to the main provisions of Chapter 11. This approach, in the absence of specific guidance in the investment chapter, ignored the counterbalance included in the preamble to NAFTA relating to environmental protection and sustainable development as equal underlying principles.

A more balanced approach is reflected in the decision of the *S.D. Myers v. Canada* dispute. (or *S.D. Myers*) where environmental concerns are noted.<sup>27</sup> However, for the first time in an investment case, the *S.D. Myers* decision also incorporates the broader trade objectives of NAFTA directly into the interpretation its investment provisions. For example, one finds the infusion of least-trade restrictive rules into the interpretation of national treatment under Chapter 11, despite the complete absence of any reference in the text of Chapter 11 that supports this approach (*S.D. Myers*, paragraphs 238-257).

Both of these cases highlight the need to incorporate specific principles and objectives inside any chapter on investment that may emerge in the FTAA, rather than leaving this role to an overall statement of objectives more relevant to trade than investment issues. They also highlight the need to ensure a balanced set of objectives for interpretational purposes.

#### *b) National Treatment and Most Favored Nation Treatment*

The basic principle of the national treatment and most favored nation treatment disciplines are to treat foreign investors no less favorably than other domestic investors or investors from other countries. Given the ability of governments to create their own list of exempted sectors from the investment regime, and the anticipation this approach will continue, once countries have made a choice as to what will be covered this discipline appears appropriate. However, three types of issues arise from an environmental perspective. One is to ensure appropriate sensitivity to environmental laws and decision-making processes that set thresholds for ambient air and water quality. Such thresholds may well mean that newer investors face higher environmental standards than previous investors, as ambient air quality decreases with additional polluters. Adjusting for such situations should not raise issues of discrimination.

A second issue may relate to the ability of investors to be held liable for any environmental damage that does arise. Domestic investors may have significant assets in their home country that foreign investors do not possess. This may lead to requirements for bonds or other means to address potential liabilities that again reflect different financial circumstances that can arise in the event of an environmental consequence arising from the operation of a business. To our knowledge, neither this nor the preceding issue has been raised in any litigation under investment agreements.

Both the above examples raise issues concerning the meaning of “like circumstances.” This term is used to limit the scope of when national treatment disciplines must be met, i.e., foreign investors that are “in like circumstances” with domestic investors must be treated in a no less favorable manner. It will be important to establish some sense of the appropriate ways for treaty interpreters to apply this notion in an environmental regulation context.

Thirdly, but closely related to the “in like circumstances” concern, *S.D. Myers* raises a serious issue as to the scope of comparison for national treatment purposes. In this case, the

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<sup>27</sup> This dispute involved the US-based company S.D Meyers (petitioner) and the Government of Canada. The subject of the dispute was the export ban on PBC waste established by the Canadian government, which the petitioner claimed to cause him losses of \$20 million.



Tribunal expanded the scope of comparison beyond comparing the foreign investment with other similar domestic operations (waste brokers) and included the investor's home state waste disposal operations within the comparative framework. This meant that national treatment was required to the full business line of the investor, not just the investment located within the host country. It was the fully integrated operation of the home and host country facilities that was compared to similar operations located wholly within Canada, despite the fact *S.D. Myers* made a specific decision, noted in the case, not to establish disposal facilities in Canada. (S.D. Myers, 2000, pages 52-59) In light of this expansive approach, negotiators may need to carefully consider explicit language to establish the scope to be applied in choosing national treatment comparisons.

*c) Minimum international standards*

Most bilateral investment agreements and NAFTA's Chapter 11 contain provisions requiring host countries to treat foreign investors in a manner that complies with minimum international standards of treatment. These provisions include terminology such as treatment in accordance with international law, fair and equitable treatment, and full protection and security. The intention of these provisions was to provide a floor of minimum standards of treatment, regardless of whether domestic firms were being treated "equally badly" by the government in question. However, there was never any specific definition put to these types of terms.

The NAFTA experience now shows their increasing applicability to environmental law making. This is seen in *Metalclad*, where the scope of the minimum international standards provision of Article 1105 of NAFTA was held to include procedural requirements for full transparency of all national and sub-national laws, the need to ensure the investors own legal advice is correct if a question arises, extensive rights of access to the decision making process, and so on. (*Metalclad* paras. 75-100)

While the initial assessments of this discipline in the NAFTA context suggested this was not an area of concern from an environmental perspective, (e.g., Mann and von Moltke, 1999), the scope of the *Metalclad* decision, with some support in the *S.D. Myers* decision (paras. 258-269), does raise important questions as to the scope of this provision. A third case, *Pope and Talbot v. Canada (Pope and Talbot)* was still considering the scope of this discipline at the time of preparing this paper.<sup>28</sup>

Given the now evident potential for an expansive interpretation of such provisions, negotiators ought to consider the scope they wish such a provision to have, whether their own law and regulation making standards fall within such a scope, and define the obligations accordingly in light of the existing and emerging jurisprudence.

*d) Performance requirements prohibitions*

The basic intention of provisions under the title of performance requirements is to prevent a host government from imposing conditions such as minimum or maximum levels of import or export of manufactured products, to incorporate a given level of domestic inputs or services into their business operations, technology requirements, mandating technology

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<sup>28</sup> This dispute involved the US-based company Pope and Talbot Inc. (petitioner) and the Government of Canada. The dispute is related to the US-Canada Softwood Lumber Agreement which the petitioner claims has been implemented in a discriminatory fashion.

transfers or personnel requirements. The objective is to ensure that the ability of an investor to maintain the full efficiency of the operation is not compromised (Brooks 1997).<sup>29</sup>

The concern that has arisen from this provision in Chapter 11, however, is that it provides private companies the ability to challenge the imposition of any general trade measure that has an impact on its production inputs or product sales in an arbitration process under the investment rules, thereby bypassing the state-state process for such challenges seen elsewhere in the NAFTA and other trade regimes. This ability has now been confirmed in three Chapter 11 cases.<sup>30</sup> Indeed, the cases now indicate that the performance requirement provisions can be used to challenge even general trade measures taken in a non-discriminatory manner, as long as there is an impact on the protected foreign investor.

Once again, the jurisprudence urges negotiators to proceed with some caution and deliberateness in setting out provisions on performance requirements, and when these should apply to generalized trade measures as opposed to specific requirements on a given investor.

#### e) *Expropriation*

The most debated issue in terms of the relation of the investor protections to environmental law-making has been the provisions on expropriation. Here, the critical issue that has emerged is the relationship of expropriation to the issue of the normal exercise of the “police powers” of a state to protect its environment and the health and well-being of its public. A secondary issue today is the language used to express what constitutes expropriation, creeping expropriation, measures tantamount or equivalent to expropriation, etc. This second problem arose in the Chapter 11 context due to the use of three terms in Article 1110 on expropriation. This issue has been largely resolved now by the jurisprudence, which has essentially held that two of the terms are repetitive terms expressing the same concept rather than terms that create new types of expropriative conduct. However, negotiators should continue to be mindful of the need for consistent and known terminology, or for appropriate explanations if new terms or phrases are used.

On the key issue of police powers and its relationship to expropriation, it must be understood that the non-recognition of a police powers rule leads to the coverage of environmental laws within the expropriation provision. “Police powers” is a traditional international law term that refers to a state’s ability to protect its territory and its citizens is not captured within the scope of the expropriation concept. In trade law or investment law terms, it is a carve out from the scope of what might otherwise be considered expropriative conduct. (Mann and von Moltke 1999, section 3.7) However, at least two of NAFTA’s Chapter 11 cases now support the non-recognition of the police powers rule.

In *Metalclad*, the Tribunal states, expressly and concisely, that “The Tribunal need not decide or consider the motivation or intent of the adoption” of the environmental measure there in question. (*Metalclad*, para. 111) That measure withdrew land from potential use as a waste management facility or other industrial uses in order to create an ecological reserve. Had the Tribunal held that such changes of land use, while in the public interest, normally require compensation to be paid to the landowners, as seen in almost all OECD and many other countries, it is unlikely much controversy would have arisen. However, they went in another direction to say the **purpose** is simply not relevant. When this is applied in a broader

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<sup>29</sup> See Moran (1998) for a case on why these performance requirements are negative for developing countries.

<sup>30</sup> *S.D. Myers*, paras 289-300; *Pope & Talbot*, paras. 74; and in the *Ethyl v. Canada* Decision on Jurisdiction, 62-64. There is no jurisprudence to the contrary.

context, it clearly would include the purpose behind other forms of environmental protection law and thus vitiate the application of the police powers rule.

The test *Metalclad* did apply is one of the **scale of impact** of a measure on a business, and whether there was a significant impact on “the use or reasonably-to-be-expected economic benefit of property, even if not to the obvious benefit of the host State.” (*Metalclad* 2000, para. 103) This approach of focusing on the scale of impact—as opposed to the purpose of the measure—and whether it is significant or not, is repeated in the *Pope & Talbot*, with extensive reference to US international law doctrine as a basis for this approach. (*Pope & Talbot*, paragraphs 96-105) What the threshold is for a significant interference is not clear in either case, though *Pope & Talbot* notes that a negligible impact of a measure on an investor’s business will not qualify. What is more critical, however, is that both cases turn to the scale of impact rather than the purpose behind a measure as the main test for considering whether any governmental action will fall within the scope of the expropriation provision.<sup>31</sup>

The result of these cases is not just to limit the scope of the police powers rule, but also to eliminate it completely from consideration in the review of an expropriation claim under Chapter 11. If the intent of the legislation is not a relevant factor, but only the scale of its impact, then NAFTA’s Chapter 11 does not admit of any scope for the exercise of police powers without paying compensation. Given that any environmental law worth adopting must have an impact on business operations, and may indeed often end certain product uses or the trade in certain products, it is difficult to imagine any such law or regulation not having a significant impact.

Given this state of jurisprudence, there is convincing evidence that negotiators of an expropriation provisions will need to carefully consider the relationship of such a provision to the normal exercise of a government’s regulatory powers to protect its environment and its population.

#### **4.2.1 Conclusion on NAFTA’s Lessons**

While it is legitimate to note that the jurisprudence has not yet fully matured in relation to Chapter 11, this does not alter the reality that all the existing case law has generated a consistent set of results that place the investor’s rights ahead of the governmental ability to protect the environment. There is little question about the trend in the cases to turn the polluter pays principle into a pay the polluter rule of law. The necessary solution, then, is not the elimination of the expropriation provision, but a full recognition of the police powers rule in order to create a common and clear understanding of the ongoing ability of governments to protect the environment and human health. Similar reviews of all potential provisions should also be undertaken.

The most problematic aspects of the trade and environment debate stem in large measure from instances of developed countries seeking to impose environmental standards on developing countries. What we see here, however, is the very real risk of investment agreements preventing developing countries taking the steps needed to protect their own environment and their own citizens for the benefit of developed country-based businesses. There is a critical need to avoid creating hemispheric-wide provisions that could constrain the ability of governments to protect the environment and their public.

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<sup>31</sup> In *S.D. Myers* express reference to expropriation not normally covering government regulation is found, but the decisions creates a genuine ambiguity by then concluding that the main reason the particular measure in question does not fall within the scope of Article 1110 of NAFTA is that it is a temporary measure. Hence, the impact of this case, while potentially constructive, is self-limiting (Paragraphs 279-287).

## 5. A New Political Context

The need to pay attention to the sustainability dimension of the investment regime is further supported by a new negotiating reality: the active engagement of civil society in investment and trade debates is here to stay. The international trade and investment agendas have suffered dramatic setbacks with the demise of OECD-anchored Multilateral Agreement on Investment (MAI) and the collapse of the trade talks during the III WTO Ministerial Meeting in Seattle.<sup>32</sup> While there was not one single factor explaining the collapse of these negotiations—many of the problems were self-inflicted—the strong opposition from non-governmental organizations (NGOs) played a significant role in derailing both agendas.

Of all the nine negotiating areas of the FTAA, the investment chapter is particularly vulnerable. The role of investors (transnational corporations, in particular) is at the core of the Seattle-fueled hostility about globalization. Even if some of the fears are overstated, issues such as the imbalance between the investors' rights and responsibilities and about process cannot be dismissed as groundless. The discussion above highlights that their instincts on the substantive shortcomings of the NAFTA's Chapter 11 were on the right track. Equally important, their concerns about the secrecy of the negotiating process cannot be overlooked. The traditional view of negotiations as a "governments-only" process no longer holds. In the FTAA context, building a new culture of openness is a *sine qua non* condition for creating public trust in the process.

This new culture must also be extended to the dispute settlement elements of the investor-state process. Few concerns have matched that raised by the ability of investors to challenge government acts through a secretive arbitration process. This is an issue that can be addressed by ensuring any such process under the FTAA is publicly accessible in terms of documents, hearings, and results. The political costs associated until now with the NAFTA investor-state process can be significantly reduced if public accessibility is addressed in a serious way in the FTAA.

The FTAA Committee on Governmental Representatives on Civil Society, while setting an unprecedented step in the right direction—at least in the Latin American context—has clearly failed to have any impact on the discussions. Moreover, the anti-disclosure stance vis-à-vis the substance of the process can only increase the skepticism about the willingness of the negotiators to effectively address key concerns outside the trade community.

In the face of increased hostility toward economic liberalization, is there a compelling reason why the FTAA would be immune to this political reality? The answer is no. Quite the opposite, the pressure from civil society is bound to increase as the FTAA process moves forward. Ignoring this challenge will continue to weaken the public support—and legitimacy—that any major trade and investment liberalization effort requires.

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<sup>32</sup> For an analysis of the collapse of the Seattle talks see Schott (2000) and the comments posted at the Journal of International Economic Law by Horlick et al. (2000). For two contrasting views on the collapse of the MAI talks see Henderson (1999) presenting a pro-MAI perspective and Wood (2000) offering an analysis of the anti-MAI campaign and a defense of it.

## 6. Opportunities for a Sustainable Investment Regime for the Americas

An often-repeated approach to addressing the problems in the context of Chapter 11 has been the suggestion to adopt an interpretive statement as permitted by Article 1131(2) of NAFTA. In the FTAA context, of course, the agreement is only in its nascent stages, allowing negotiators to address the issues of concern in a wider variety of ways. Drafting alternatives include direct provisions in the text, which will be required to address some issues, interpretive notes as an add on to the text, appropriate preambular paragraphs and objectives provisions located specifically in the investment chapter of an FTAA. Despite the importance of this exercise, it is not the objective of this paper to prescribe the most appropriate form for addressing the issues, in particular as no draft text is yet publicly available by which to make informed comments on an appropriate form.

While no recommendations are made here as to specific language or one specific form, we believe that the following recommendations should be considered in addressing both aspects of the investment/sustainability relationship discussed in section 4, as well as the transparency issues raised in section 5. Many of these recommendations are influenced by approaches suggested by the Environment Division of the OECD Secretariat in the context of the MAI negotiations.<sup>33</sup>

### 6.1 The Promotion of Investments that Promote Sustainability

Using an investment agreement to promote sustainable investments as opposed to simply promoting investments would indeed be breaking new legal and economic ground. This is not an easy task. Yet many of the tools that can be envisioned for doing so that are familiar to governments, business and NGO's. By including some of these tools, negotiators can move to a focus on quality investments with a longer-term commitment to sustainability. Specific suggestions in this regard include:

- Including the need to promote investment that support sustainability in the *preamble or objectives* of the investment regime: This recommendation arises both here and in the next sub-section. Its importance here is to shift to the recognition of the need for sustainable investments as opposed to simply investments.
- Provisions setting out *governmental responsibilities and obligations* in relation to the substance and enforcement of environmental law should be set out. Minimum provisions in this regard include provisions that would bar the lowering of environmental standards in order to attract or maintain investments, and to ensure the effective enforcement of environmental laws.
- Provisions to promote *high environmental standards* should also be included, while recognizing that varying local conditions will militate against the harmonization of environmental standards across the hemisphere. Appropriate review or enforcement

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<sup>33</sup> The informal paper "What Would an MAI With High Environmental Content Look Like?: OECD Internal Working Document", was reprinted in *Bridges*, Internal Briefing No. 3, International Centre for Trade and Sustainable Development, November, 1997.

mechanisms for such provisions can be specifically tailored to the more general nature of such provisions.

- Provisions to set out *corporate responsibilities and obligations* should also be included in the substantive provisions of an investment agreement. These can include provisions requiring the undertaking of an environmental impact assessment in accordance with host country/home country/World Bank standards prior to the investment takes place, and maintaining a certified environmental management system (e.g. ISO 14001<sup>34</sup> or an equivalent) during the life of the facility.
- Investment provisions can require compliance with *local environmental laws*, as already required by adherence to ISO 14001. In addition, a requirement to act in a manner consistent with the obligations assumed by both the host country and the home country in any international environmental agreements should be set out. This would ensure that investment agreements do not inadvertently provide a mechanism for host country shopping to avoid the constraints derived from international environmental law.
- High levels of corporate conduct by foreign investors can be encouraged by removing barriers to suit of the foreign investor in their home country, including such rules as the *forum non conveniens* rule.

The negotiation of the FTAA provides an important opportunity for reflecting carefully on the need for capacity building to ensure not only that government officials have the ability to assess the environmental impacts of foreign investors proposals, but also domestic investor proposals. Capacity building for domestic investors would also be an important step forward. The FTAA process can provide a catalyst for this type of capacity building within the broader Summit of the Americas context. But, such parallel effort would no be sufficient. The investment negotiations themselves provide an opportunity to take a long-term perspective on one critical element of the development process – FDI – and the lack of government capacity to fully undertake all its potential responsibilities vis-à-vis investors should not be a basis on which to avoid addressing the responsibilities of governments. Much less is this a valid reason to avoid facing the duties of the foreign investors who, by virtue of the investment agreement, will receive additional rights and remedies over those enjoyed by domestic investors.

## **6.2 Preventing Negative Impacts on Environmental Law Making**

Section 4.2 highlighted the main concerns raised with the wording of NAFTA's investment chapter. The recommendations below set out opportunities to avoid the same pitfalls in the FTAA context, and to help ensure that an investment section in the FTAA does not hamper government actions in response to environmental problems.

- Negotiators should incorporate explicitly *sustainability-related objectives and principles into the preamble* or a section of objectives of the investment chapter that will guide interpreters, especially in a dispute resolution context. This explicit language could provide specific

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<sup>34</sup> ISO 14000 is a series of international, voluntary environmental management standards. Developed under Technical Committee of the International Organization for Standardization, ISO. The 14000 series of standards address several aspects of environmental management including auditing; labels and declarations; and life cycle assessment. More information available at <<http://www.iso.ch>>.

guidance for the different issues that arise in the investment as opposed to trade context and reduce the possibility of applying objectives define for the trade context, most of them inappropriate for the interpretation of investment disciplines.

- Negotiators should pursue a balance between the economic and environmental aspects of the principles and objectives, as they will be a touchstone for treaty interpreters when conflicts emerge.
- In relation to the principle of *national treatment* (and by extension the principle of most-favored nation), negotiators should consider the need for some guidance in relation to environmental regulation and what constitutes “*like circumstances*.” As well, the scope of the comparisons for what national treatment and like circumstances mean needs to be considered carefully to ensure that domestically situated facilities are the ones accorded national treatment, not the all the combined operations of the investor’s facilities located both inside and outside the host country.
- Given the now evident potential for an expansive interpretation of provisions on *minimum international standards* negotiators ought to specifically consider the scope they wish such a provision to have, and define the obligations accordingly, and in light of the existing and new jurisprudence.
- The emerging Chapter 11 jurisprudence urges negotiators to proceed with some caution and deliberateness in setting out provisions on the prohibitions of *performance requirements*, and when these should apply to generalized trade measures (such a trade ban) as opposed to specific requirements on a given investor (such as technology transfer). This *threshold issue* appears to require fairly precise determination to prevent private companies from having the capability to litigate any trade measure taken by a government with an impact on them based on the argument that it represents a “performance requirement.”
- As regards the *expropriation provisions*, the most critical issue appears to be for negotiators to ensure there is a full recognition of the “police powers” rule in order to create a common and clear understanding of the ongoing ability of governments to protect the environment and human health without fear of having to pay compensation for doing so. A secondary element is to ensure that no ambiguous terminology is introduced into the expropriation provision that could raise questions about new forms of expropriation through regulatory means, while recognizing that creeping expropriation may indeed be a relevant concern. This discussion has almost been “solved” in the NAFTA context and the lessons should be considered explicitly in the FTAA process.

### **6.3 Transparency**

Transparency in the dispute resolution process is an essential requirement for the public acceptance of and trust in the investor-state process. Given the pro-democratization element of the Summit of the Americas process, there is a need to reflect this goal in the investment chapter. The transparency provisions should include:

- Provisions for *public access* to documents and pleadings during an investment dispute (as the ones offered in domestic court proceeding) and access to other information such as notices of intent to arbitrate and the notices of arbitration. In addition, there is a need to establish appropriate conditions for the participation of friends of the court brief or

*amicus curiae*,<sup>35</sup> to allow public access to proceedings, and to ensure publication of all awards and decisions of panels.

- Responses to the significant changes in public awareness about the pros and cons of trade and investment liberalization and its resulting political implications. Negotiators must respond to these changes through an *open process* with public access to the negotiations, draft negotiating documents, and national position papers. Some international environmental negotiations (i.e. the process leading to the Cartagena Protocol on Biosafety) provide a useful model for organizing public access to governmental processes in a manner that meets demands on transparency while respecting the need for efficient negotiating processes.<sup>36</sup>

## 7. Final Remarks

The high profile of investment-related issues in the public perception of trade and investment liberalization cannot be escaped today. In many ways, the issues raised by the substance of Chapter 11 of NAFTA—but also in the MAI negotiations—qualify as the “poster child” in the public mind for the negative impacts of globalization. Despite some overstatements and simplifications by some, many concerns about Chapter 11 of NAFTA are warranted. This paper has tried to shed some light on the specific challenges that the architects of the hemispheric investment regime need to address. The FTAA negotiations on investment provide an opportunity to address the substantive issues as well as the procedural failures of the past that the NAFTA negotiators lacked at the time.

The one-dimensional scope of the FTAA investment chapter needs to be reconsidered. The negotiators should not ignore the practical consequences of placing investment protection as the only priority of an investment regime for the Americas. The failure to broaden the scope and purpose of such a regime can only create political opposition to the process, with similar consequences to those encountered by the MAI process.

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<sup>35</sup> The capacity to allow *amicus* participation has recently been recognized by a Chapter 11 Tribunal hearing the *Methanex* case against the United States. (Methanex, 2001)

<sup>36</sup> For a discussion of schemes for public participation in international for a see ICTSD (1999).



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## 9. Cited NAFTA's Chapter 11 Cases

(All of these cases are available at <<http://www.naftalaw.org>>.

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*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

*Methanex Corporation v. United States of America*. Decision of the Tribunal on Petitions From Third Persons to Intervene as "Amici Curiae", 15 January 2001.

*Pope & Talbot Inc. v. Canada.* In The Matter of an Arbitration Under Chapter Eleven of the North American Free Trade Agreement Between Pope & Talbot Inc. and the Government of Canada, Interim Award by Arbitral Tribunal, June 26, 2000

*S.D. Myers v. Canada.* In a NAFTA Arbitration Under UNCITRAL Arbitration Rules, S.D. Myers, Inc. v. Government of Canada, Partial Award, November 13, 2000

## 10. Annexes

### Annex 1

#### **FDI-Environment: A Conceptual Framework**

There is no overarching conclusion on the “FDI and the Environment” linkage. Several frameworks have been suggested. Zarsky (1999) has developed a very useful framework for organizing the discussion under 3 sets of linkages: micro linkages; policy linkages; and macro linkages:

##### **A) Micro-Linkages: Impacts on Firms**

There are two broad issues, one is industry location and the other one is firm-level environmental performance:

- *Impact of environmental standards on firm/industry location and on investment decisions; (e.g. the “Pollution haven” discussion on whether “dirty” industries would relocate where compliance costs are lower).*
- *Impacts of the foreign company’s technology, management, and size on its environmental performance. (E.g. the “Pollution halo” discussion on whether FDI is a vehicle by which to diffuse “best practices” through the world).*

Evidence shows that impacts can be positive, negative, or neutral. The results are context-dependent.

##### **B) Policy Linkages: Impacts on Environmental Standards**

These linkages focus on the impact of economic processes (such as economic integration) on environmental standards and norms.

- *Impacts of international competition for FDI on environmental regulation and norms. (E.g. the discussion on the “race-to-the-bottom hypothesis” the fear that concerns about gaining or retaining competitiveness will provoke a downward harmonization of environmental standards).*

Evidence shows that while there is no universal race to the bottom, but there is no race to the top, instead many standards could be “stuck in the mud.”

##### **C) Macro Linkages: Scale Impacts**

FDI can influence at least 6 macro environmental variables. Thus FDI increases could have impacts on:

- *The scale of ecological degradation and use of environmental space (perhaps the greatest concern of environmentalists).*
- *Ecosystems and environmental policy as income and consumption increase;*
- *The local tax base and the provision of public goods (e.g. water management infrastructure).*
- *The domestic political economy, for example, environmental decision-making. (This is clearly related to the discussion on the effects of NAFTA’s investment provisions on local authorities).*

Continues

## **FDI-Environment: A Conceptual Framework (Cont.)**

- *Social conditions* (e.g. workers health and safety);
- *Cross-border externalities and consequently the impact of these on international conflict and co-operation.*

Evidence suggest that there is a gap even between the incremental improvements in firm-level performance and the scale of ecological impact caused by unsustainable production patterns at the global level.

O'Connor (2000) analysis of global capital flows and the environment suggests, among other things, that at least two more components of the FDI-Environment interplay:

### **D) Environmental Accountability**

The level of environmental accountability of multinational corporations is directly impacted by the environmental sensitivities of their major shareholders, customers, and creditors. The bigger the size of corporation, the more visible, thus the more public scrutiny it will be exposed to.

### **E) The Investment-Trade Linkage**

Since there is a strong connection between investment flows and trade is difficult to analyze the effects of FDI on the environment without considering the associated trade flows and their environmental repercussions.

Sources: Zarsky, L. 1999. Havens, Halos, and Spaghetti: Untangling the Evidence about Foreign Direct Investment and the Environment. Paris: OECD. O'Connor, D. 2000 Global Capital Flows and the Environment in the 21<sup>st</sup> Century. Paris: OECD

## Annex 2

### Summary of NAFTA's Chapter 11 Known Environmentally-related Disputes

<b>Petitioner (Investor)</b>	<b>Defendant (Government)</b>	<b>Claim</b>	<b>Status (March 2001)</b>
Ethyl Corporation (United States) September 1996	Canada	Import ban on gasoline additive MMT.	Case settled in 1998 for US\$13 million. Canada eliminated ban on MMT imports.
Metalclad Corporation (United States) Oct. 1996	Mexico	Mexico State and municipal decisions preventing the location of a hazardous waste landfill.	August, 2000: Tribunal finds for Metalclad and orders Mexico to pay Metaclad \$16.7 million in damages; Award subject to an application for review and appeal in Superior Court of British Columbia. May 2001: Canadian Court ruled in favor of Metalclad. *
S.D. Myers (United States) July 1998	Canada	Export ban on PCB waste exports	Nov. 2000: Tribunal decides in favor of S.D. Myers, with a second stage on amount of damages to follow; Feb. 2001: Canada launches an application for review of award in Federal Court of Canada
Desechos Sólidos de Naucalpan C.V. "DESONA" (United States) December 1996	Mexico	Alleged breach of contract to operate a landfill and seizure of property	October 1999: Resolved in favor of the Mexican government on jurisdictional grounds.
Waste Management	Mexico	Alleged breach of contract to operate waste services	June 2000: Initially resolved in favor of

<b>Petitioner (Investor)</b>	<b>Defendant (Government)</b>	<b>Claim</b>	<b>Status (March 2001)</b>
“Acaverde” (United States) June 1998			Mexico on jurisdictional grounds, re-instituted in September, 2000 and now pending
Sun Belt Water Inc. (United States) November 1998	Canada	Allegedly biased treatment by Government of British Columbia in a joint venture.	Status unclear, no formal arbitration process initiated to date
Pope & Talbot Inc. (United States) December 1998	Canada	Export quotas to implement the US-Canada Softwood Lumber Agreement	Ongoing. The tribunal has dismissed two of the four claims made by Pope & Talbot in a June 2000 decision
Methanex Corporation (Canada) June 1999	United States	California state ban on the use of MBTE (gasoline additive)	Ongoing. Noteworthy: In January 2001 there was a unprecedented decision of the Tribunal on “Petitions From Third Persons to Intervene as “ <i>Amici Curiae</i> ”**

Sources: Hufbauer et al. (2000); Mann and von Moltke (1999).

\* For more information see the Press Release “MetalClad Welcomes Canada Court Ruling In NAFTA Investment Dispute.” *Inside US Trade*. 5-3-2001

\*\* The International Institute for Sustainable Development (IISD) has sought to intervene as a friend of the court in this case. In January 2001 the Tribunal ruled that it has the authority to hear *amicus briefs*. More information (including the Tribunal's decision) is available at <[http://iisd.ca/trade/investment\\_regime.htm](http://iisd.ca/trade/investment_regime.htm)>