Introduction

Foreign direct investment (FDI) is widely seen as a major contributor to the economic development and continued growth of numerous developed and developing states around the world. FDI can play a vital role in the development process of host- as well as home-states. In addition to providing capital inflows and tax revenue, FDI can be a vehicle for increasing employment and upgrading the skills of the local workforce. It can contribute to the establishment and expansion of infrastructure and in some cases lead to advances in technology. However, neither inflows of FDI nor the benefits associated with them should be viewed as the automatic consequence of the activities of internationally mobile firms taking place in foreign countries. It is far from clear that the aggressive pursuit of international investment agreements or World Trade Organization (WTO) membership will lead to an increase in FDI that is beneficial to host states. This is precisely why there is increased awareness of the need for policies that can not only incentivize the acquisition of FDI, but that can augment the developmental benefits associated with it through the application of conditions crafted according to the requirements of the host state. Performance requirements dictating the nature and extent of inward FDI have the potential to operate as market distortions, causing firms to behave otherwise than how they would choose to behave of their own accord. Likewise, investment incentives aimed at encouraging the inward flow of FDI may create costs that are difficult for both host states and firms to predict and manage effectively. It can be problematic for governments issuing incentives to identify the precise conditions, (for example, type of incentive, industry, and duration) under which incentives will operate to fulfil their economic goals.

In many ways, the debate surrounding the use of tools such as performance requirements and investment incentives to manipulate FDI flows can be framed as an issue linked to the rise of emerging markets as key participants in economic globalization. As developing countries become industrialized, they increasingly rely on FDI as a source of growth; and in so doing they have begun to seek to implement some of the regulatory strategies that their developed country counterparts instigated in the twentieth century, even as these are in some cases contrary to
Performance requirements and investment incentives under law

economic liberalization. These strategies include not only membership in multilateral organizations like the WTO and the International Monetary Fund (IMF), nor simply the signage of international investment agreements, but also the inclusion of provisions restricting the powers of their trading and investing partners to interfere with FDI. During the so-called “second wave” of globalization, marked by the ascendency of the large emerging markets, the rise in prominence of services in the global economy may have rendered the use of traditional performance requirements, such as local content rules, largely self-evidently counterproductive. At the same time, however, the more recent period of globalization has shown a distinct increase in a broad array of governmental incentives instigated in order to increase the inward flow of FDI in what has become a competitive global marketplace for wealth-generating firms. As such, performance requirements increasingly appear to take the form of conditions attached to incentives, rather than as simple limits on the extent of FDI.

Indeed, performance requirements can be accurately described as conditions imposed on foreign investors that they must achieve certain goals with respect to their commercial activities in host countries. This is why they are sometimes referred to as “conditional investment incentives”. They are used along with other policy tools, such as traditional investment incentives, to attain certain economic development objectives. Investment incentives can be defined as any measurable advantages accorded to specific firms or categories of firm by a host government in order to encourage them to engage in operations of a certain variety; typically, this means FDI of a certain quantity or in a certain sector. This book will adopt a consciously broad definition for both performance requirements and investment incentives in order to provoke a critical assessment of the existing treatment of these instruments under international economic law. The understanding of these concepts, rooted in the notion of discrimination based on national origin, will embrace a wide range of measures and accordingly engage many disciplines.

Performance requirements and investment incentives are among a wide range of policy tools that may address some of the concerns associated with unbridled FDI, including uncompetitive domestic markets and over-reliance on foreign capital, allowing them to optimize the positive impact of FDI. Yet despite their importance to the economies of host states, the use of investment incentives has attracted remarkably little attention by scholars (especially from a legal perspective), with performance requirements faring even worse, receiving virtually no attention whatsoever from the academic legal community. Moreover, although
performance requirements and many incentives are employed by governments throughout the world, there remains profoundly limited information about their impacts as tools of economic as well as (often less-recognizably) social policy. Furthermore, since performance requirements are now regularly used in conjunction with investment incentives, it is misleading to consider investment incentives without also discussing performance requirements. The interrelated nature of performance requirements and investment incentives is captured by the fact that the former may be negotiated as a quid pro quo for the latter. Moreover, as incentives tend to be designed to compensate for certain disadvantages that have resulted from performance requirements, the prohibition of entrenched performance requirements might well reduce the need for incentives over the long term.

Some varieties of investment incentives, including most notably fiscal, have been criticized by international organizations as inefficient because they are too expensive relative to their benefits, especially when taking into account their long-term effects on the environment and other social issues. Some of the most advantageous forms of incentive, such as those tied to performance requirements like the provision of infrastructure or knowledge exchange, may not be used as widely as they should be. Investment incentives can be further problematic because, while they may help specific firms or under-performing industries, on a macroeconomic level they can distort markets and result in an efficient allocation of both public and private resources that would be more productively spent elsewhere. Over-use of fiscal incentives diminishes the public funds available to provide essential public goods and services. Likewise, firms receiving assistance may have otherwise directed their resources at more efficient production lines or more profitable markets overseas. On the other hand, incentives can be a vital method of achieving crucial economic goals such as addressing underserved markets. The need for incentives to attract FDI is grounded in the reality that market failures exist in which mutually beneficial investment activities are not fully appreciated by foreign investors. Such failures are tied to information asymmetry between firms and host states as well as externalities associated with foreign investment, including in some cases suppression of the development of an entrepreneurial class and the over-reliance on foreign capital. Incentives can foster positive outcomes that may not be possible through the normal operation of the market. It can stimulate the production of public goods, such as infrastructure, underemployment and research and development. Moreover, incentives, particularly when linked with performance requirements, can help mitigate negative externalities, such as environmental damage.
The capacity of host governments to enact policies to tailor the nature and extent of the FDI they receive is founded upon the principle that states are fundamentally entitled to assert sovereignty over their own economies even as they participate in economic globalization. The principal of permanent sovereignty over natural resources (PSNR) embodies the right of states and their peoples to dispose of their natural resources as they see fit. Since the state has the legitimate discretion to regulate in the public interest, this supreme right can potentially result in conflict with the rights of foreign investors under international investment law. Under public international law, the state should not relinquish its sovereignty for any reason. The General Assembly of the United Nations sought to establish a link between resource-sovereignty and development by elaborating on the foreign-investment-related provisions of PSNR. This was captured in the General Assembly’s resolution on PSNR, Resolution 1803. This resolution states that nations must be able to exercise sovereignty over their natural resources in the interests of their national development and well-being, which overrides individual private interests, both domestic and foreign.1 This principle is also reflected in Resolution 3281 of the Charter of Economic Rights and Duties of States, which confirms that every state shall freely exercise full permanent sovereignty including possession, use and disposal over all of its wealth, natural resources and economic activities, supplemented by the duty of states to compensate any private parties which suffer deprivation as a consequence. States may accept commitments not to exercise certain sovereign rights for a time in order to attract foreign investment, but this does not mean that the state is abandoning the doctrine of PSNR. In other words, the recognition of a state’s right to offer investment incentives should not be seen as a derogation of a state’s sovereignty because international law also recognizes a state’s capacity to commit itself internationally, just as it empowers a state to control its natural resources.

The prohibition of performance requirements addresses trade in goods and services, and it does so at the point where the disciplines of trade in goods, trade in services, and investment intersect. The major regimes under international economic law which restrain state’s sovereign capacity to use performance requirements and investment incentives are those of the WTO and the many thousands of international investment agreements (IIAs) which operate either bilateral or regionally. The WTO is a member-driven and rules-based international organization with a

---

1 UNGA Res. 1803 (XVII) (14 December 1962).
membership of 161 countries worldwide that promotes the free movement of goods and services across international borders through the elimination or reduction of regulatory protectionism instigated at the domestic level. Established in 1995 but effectively operating through the stand-alone General Agreement on Tariffs and Trade (GATT) since the 1940s, the WTO now has specific disciplines relating to non-tariff barriers to trade such as subsidization, anti-dumping, safeguards, as well as intellectual property and technical barriers to trade. It also maintains its own dispute-settlement mechanism, the WTO Dispute Settlement Understanding, which facilitates the resolution of disputes among its member states as to the interpretation and implementation of its covered agreements.

While the WTO has a mandate of liberalizing trade (in both goods and services) and not investment, laws that prevent unnecessary barriers to trade may also affect barriers that can be imposed on foreign investment. The primary regulatory sphere of the WTO in this regard is the Agreement on Trade Related Investment Measures (TRIMs). Similarly, the WTO’s control of subsidies as an unfair distortion to global trade through the Agreement on Subsidies and Countervailing Measures (SCM) may have an impact upon the extent to which states can offer assistance to foreign firms in order to encourage FDI. For their part, the de-centralized network of IIAs, most of which consist of highly standardized language, contain direct prohibitions on performance requirements but tend to say very little about investment incentives. Yet some of the protections found within these instruments could themselves be viewed as incentives, particularly where they ensure that continued advantageous treatment is forthcoming. In addition to the binding laws imposed on host countries by the WTO and IIAs, there are several soft-law instruments promulgated by international organizations such as the Organisation for Economic Co-operation and Development (OECD) and the World Bank that can influence if not the ability then at least the willingness of states to implement these policy tools to achieve economic developmental or social aims.

This book will demonstrate that international economic law has failed to regulate performance requirements and investment incentives effectively, often resulting in market distortions on both a national and global scale as well as lost opportunities for the stimulation of productive FDI in certain situations. It will do so by examining the approach taken to the control of these instruments by both trade-based regimes (the WTO and regional trade agreements) and investment-based regimes (IIAs). The division of the book into performance requirements and investment incentive is self-explanatory: it reflects the different objectives and
regulatory approaches to two vastly different but related economic policy tools. The division between trade and investment, while somewhat artificial, is not meant to indicate a separation between two varieties of subsidy as much as it is to demark the two chief regulatory methods of regulating all types of performance requirement and incentive. Clearly some types of performance requirement and investment incentive will involve both trade and investment elements because investment and trade are often highly interrelated. As this book focuses on law rather than on finance or economics, the distinction that will be made here is therefore a legal one. There are trade laws (mainly promulgated by the WTO) and there are investment laws (mainly promulgated by IIAs). These are both used to varying degrees to address policy tools that in reality are cross-disciplinary.

The structure of this book is as follows. Chapter 1 will explore the phenomena of performance requirements and investment incentives in greater detail, outlining some of the policy justifications behind these tools and conveying the economic arguments for and against their implementation. Chapter 2 will focus on the theme of performance requirements and investment incentives as manifestations of discriminatory treatment based on nationality either against foreign firms in the case of performance requirements, or in favour of them in the case of investment incentives. In so doing this chapter will examine the national treatment requirement as it is captured in both trade and investment law. Chapters 3 and 4 will consider the trade-based controls of performance requirements and investment incentives respectively under international economic law. This will involve an analysis of WTO agreements such as the TRIMs and the General Agreement on Trade in Services (GATS) as well as provisions in IIAs such as the prohibition of performance requirements. Chapters 5 and 6 will examine how international economic law has limited the capacity of states to use investment incentives through a discussion of WTO disciplines on subsidies as well as various provisions of IIAs that could affect the use of incentives, including those which could be used to ground claims for the revocation of incentive packages by host states. Chapter 7 will conclude by offering recommendations for the improvement of the regimes that regulate performance requirements and investment incentives. In particular it will focus on the need to address imperfect information and information asymmetries, as well as the crucial importance of tying the regulation of these instruments in policies of non-discrimination. A unified regime governing both performance requirements and investment incentives will be contemplated, allowing for the evaluation of these policy tools in more comprehensive and systematic way. It will draw on reflexive governance theory
to suggest that access to ever greater quantities of information through the global digital commons can help facilitate mass collaboration between investment-promotion agencies and multinational enterprises (MNEs) to arrive at efficient decisions regarding the structure of FDI.