

# Foreign Direct Investment and Environmental Impacts – Is the Debate Over?

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## INTRODUCTION

Although there have been numerous concerns raised about its social and environmental impacts, foreign direct investment (FDI) appears to be increasing unabated. The increase can be related to numerous factors including the liberalization of the global economy, facilitated by lower tariffs on trade in goods and services and extensive economic reforms. However, FDI flows still appear to be directed towards industrialized countries. Three-quarters of FDI has been received in Japan, the USA and the EU, while the remaining quarter goes essentially to only 11 other countries.<sup>1</sup>

FDI patterns reveal that there is a stronger preference in the manufacturing and services sectors, but there is also a presence of FDI flows to developing countries and least developed countries in natural resource sectors. These developing countries often lack the economic diversification to provide opportunities for investors in other areas. Investment in natural resources has traditionally exploited limited regulatory regimes, which are often suspect to corruption and poor governance due to the high economic rents derived from the sector.

FDI has been seen as a panacea for economic development, bringing in necessary technology, expertise and financial resources to developing economies. These countries often do not have the capacity to take advantage of liberalized trade and open markets and are unable to produce items for export. FDI can offer opportunities to foster this capacity.

Increasing FDI flows may have worrying impacts for a host country's ecosystems and social development. Investors may seek countries that have a less strict, or non-existent, regulatory regime. This is termed the 'pollution haven theory'. A correlative to this is that host countries may attempt to exempt or loosen their regulatory requirements in order to attract investment. The competition for FDI may create a

'race to the bottom' of environmental, labour and other standards.

The overriding problem in measuring the extent of these phenomena is that there are inherent barriers to providing an accurate assessment.<sup>2</sup> The most difficult challenge has been in obtaining information. Any evidence that a government is modifying legal obligations to bring in investment will be unobtainable, especially since such decisions, as well as negotiations with investors, would not be made in a transparent manner. Incentives given to investors are usually given on an *ad hoc* basis.<sup>3</sup>

Moreover, there is a dearth of statistical evidence qualifying that environmental regulation plays a significant role in decisions whether to locate investment. Most studies, in summarizing the literature on the pollution haven theory, assert that empirical evidence of these phenomena simply does not exist.<sup>4</sup> This has been proven to be particularly the case for industrialized countries,<sup>5</sup> where the public scrutiny levelled at the lowering of standards is pronounced. In fact, this may only be a low-cost determinant of such a decision in comparison to the great expenses incurred in re-locating or applying differentiated, country-specific standards in their worldwide operations. Additionally,

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<sup>2</sup> This was the basis for a study conducted by the Organization for Economic Cooperation and Development (OECD) in 2001 to identify the empirical evidence supporting these trends. See OECD, *Environmental Issues in Policy Based Competition for Investment: A Literature Review* (OECD, 2001).

<sup>3</sup> UNCTAD, *Incentives and Foreign Direct Investment* (United Nations, 1996).

<sup>4</sup> D.C Esty and D. Geradin, 'Environmental Protection and International Competitiveness', 32:5 *Journal of World Trade* (1998), 5; C. Oman, *Policy Competition for Foreign Direct Investment: A Study of Competition Among Governments to Attract FDI* (OECD, 2000); J.A. Tobey, 'The Effects of Domestic Environmental Policies on Patterns of World Trade: An Empirical Test', 43:2 *Kyklos* (1990), 191.

<sup>5</sup> D. Vogel, 'Trading Up and Governing Across: Transnational Governance and Environmental Protection', 4:4 *J of Eur Public Pol'cy* (1997), 556; C. Porter, 'Trade Competition and Pollution Standards: "Race to the Bottom" or "Stuck at the Bottom"?'', 8:2 *J of Env't and Dvlpm't* (1999), 133.

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<sup>1</sup> UNCTAD, *World Investment Report* (UNCTAD, 1999).

an increasing presence of dirty industries in developing countries may simply reflect their general growth and industrialization,<sup>6</sup> a rise in in-country demand for such products,<sup>7</sup> or the countries' possession of higher natural resource endowments.<sup>8</sup>

Overall, it is difficult to make a direct causal link between the inflow of investment and the scope of environmental regulation and policy. Stronger laws may be influenced by several factors, including local and community pressures, a strong civil society movement or even initiated by the private sector. The absence of legislation may be attributed more to institutional deficits, limited resources or simply a lack of political will. Although there is some anecdotal evidence that companies may locate to countries lacking a strict environmental regime or that countries may use environmental regulation, or exemptions thereof, as an incentive, data indicating consistent patterns of these phenomena are not present. As a result, it is problematic to surmise definitively that there is, in fact, environmental regulatory competition between countries to attract foreign investment.

The following article will provide an analysis of some of the studies tracing the environmental impacts from the entry and operation of FDI. Various theories devised to demonstrate these impacts are reviewed. These include the pollution haven, race to the bottom/top and regulatory chill theories. Evidence confirming the existence of such theorem does exist when assessing studies at both the macro and micro level. It is likely that such instances will continue. However, the absence of any systematic proof will only result in limiting the impact of such findings to mere rhetoric among government decision makers.

## THEORIES ON ENVIRONMENTAL REGULATORY COMPETITION

### POLLUTION HAVENS

The 'pollution haven' theory attests that investors will seek other countries to locate their industries where

<sup>6</sup> P. Low, 'The International Location of Polluting Industries and the Harmonization of Environmental Standards', in H. Munoz and R. Rosenberg (eds), *Difficult Liaison – Trade and the Environment in the Americas* (Transaction Publishers, 1993), at 25.

<sup>7</sup> A. Markandya, 'Overview and Lessons Learnt', in V. Jha, A. Markandya, and R. Vossenaar (eds), *Reconciling Trade and the Environment: Lessons from Case Studies in Developing Countries* (Elgar, 1999).

<sup>8</sup> P. Low and A. Yeats, 'Do Dirty Industries Migrate', in P. Low (ed.), *International Trade and the Environment* (World Bank, 1992).

it will be cheaper and more efficient in light of regulatory requirements. Firms will seek investment in locations where they can exploit the comparative advantage for the maximum gain. Incentives for investors can relate to pre-entry conditions, such as existing legislation and regulations, licensing requirements and other conditions, as well as post-entry conditions, such as levels of enforcement of legislation or subsequent regulation of the sector in which the investor is present. A noted example of this is the relocation of Californian tanneries to Mexican free trade zones.<sup>9</sup>

Most literature on the subject reveals little empirical evidence that investors seek developing countries as pollution havens; however, there are a number of case studies suggesting otherwise.<sup>10</sup> The reasons for the creation of a pollution haven may be unique to a host country's situation. For instance, McConnell and Schwab found no significant evidence that regional differences in environmental regulation affected choice of location for car plants, but an exception was found in cases of countries that were exceedingly not in compliance with air quality standards.<sup>11</sup>

Examples of industrial flight appear to be anecdotal, and inconsistent with general trends based on aggregate data.<sup>12</sup> One study by Repetto indicated that outward FDI from the USA to developing countries and countries with economies in transition was at 45% but the proportion of that investment relating to environmentally sensitive industries (such as petroleum and gas, chemicals and metals) was minimal, being 5%.<sup>13</sup> However, studies of industrial flight do not differentiate the reasons for relocation.

Such trends may be more sector or industry specific. A US General Accounting Office study of the furniture industry found that some companies, who regularly incur heavy expenses for treating toxic wastes from paints, varnishes and solvents, moved out of the State of California to avoid that State's strict pollution control requirements.<sup>14</sup> The reasons for the creation

<sup>9</sup> However, data on industrial flight benefits will necessarily be dependent on a comparative analysis of environmental compliance costs. This information is regularly published only in the USA. See H. Nordström and S. Vaughan, *Trade and Environment: Special Studies* (World Trade Organization, 1999), at 4.

<sup>10</sup> See N. Mabey and R. McNally, *Foreign Direct Investment and the Environment: From Pollution Haven to Sustainable Development* (WWF-UK, 1999), at 4.

<sup>11</sup> V.D. McConnell and R.M. Schwab, 'The Impact of Environmental Regulation on Industry Location Decisions: The Motor Vehicle Industry', 66 *Land Economics* (1990), 67.

<sup>12</sup> *Ibid.*

<sup>13</sup> R. Repetto, *Jobs, Competitiveness and Environmental Regulations: What are the Real Issues?* (World Resources Institute, 1995).

<sup>14</sup> GAO, *Report on the Furniture Finishing Industry* (GAO, 1990). Solvent manufacturers were able to relocate to jurisdictions where no air pollution standards existed; see N. Mabey and R. McNally, n. 10 above.

of a pollution haven can even relate to free-riding on the principle of common but differentiated responsibility, which has become a mainstay in international environmental law. One study noted that investors relocated to Thailand to take advantage of its status under Article 5 of the Montreal Protocol, allowing them to continue produce ozone-depleting substances.<sup>15</sup> A subsequent rise in ozone-depleting substance imports between 1986 and 1991 confirmed this trend.

However, determinants of FDI migration appear to be more centred on matters such as taxation, domestic market conditions and foreign exchange restrictions. Environmental costs do not emerge as a strong factor. As a result, the strictness or laxity of environmental regulation is not determinative.<sup>16</sup> In some instances, the absence of a regulatory framework could deter investment, leaving a vacuum where much stronger legislation could be introduced undermining the security of the investment. In Central and Eastern Europe, investors were reluctant to relocate due to concerns that they may incur liability or other clean-up costs in the future.<sup>17</sup> However, FDI migration might be a factor for pollution-intensive industries.<sup>18</sup> Such industries would include chemicals, chlorine and pesticides, resource extracting and heavy manufacturing, all of which face additional correlative costs due to public relations, establishment of environment divisions in firms, liability and insurance, legal fees, occupational health and safety costs, and delays incurred during environmental impact assessments.<sup>19</sup> Clapp reports that many firms in the chlorine industry left the USA due to the government's prohibition of the land disposal of chlorine waste and a moratorium on its incineration.<sup>20</sup> Pesticide manufacturing has expanded in Mexico in contrast to the USA where the sector is strictly regulated and some products are prohibited.

<sup>15</sup> V. Jha and U. Hoffmann, *Achieving Objectives of Multilateral Environmental Agreements: A Package of Trade Measures and Positive Measures*, UNCTAD/ITCD/TED/6 (UNCTAD, 2001), at 29, available at <[http://www.unctad.org/trade\\_env/docs/booksum.pdf](http://www.unctad.org/trade_env/docs/booksum.pdf)>.

<sup>16</sup> See D.C. Esty and D. Geradin, n. 4 above.

<sup>17</sup> A. Zamparutti and J. Klavens, 'Environmental and Foreign Investment in Central and Eastern Europe: Results from a Survey of Western Corporations', in OECD, *Environmental Policies and Industrial Competitiveness* (OECD, 1993).

<sup>18</sup> Y. Xing and C.L. Kolstad, *Do Lax Environmental Regulations Attract Foreign Investment?*, Working Paper in Economics No 6-95R. (Department of Economics, University of California, Santa Barbara, 1998). This study found that US chemical companies migrated to developing countries basing their decision on the laxity of environmental regulations governing SO<sub>2</sub> emissions. Similar results were found by J. Klavens and Z. Zamparutti, *Foreign Direct Investment and Environment in Central and Eastern Europe: A Survey* (World Bank, 1995); G.S. Eskeland and A.E. Harrison, *Moving to Greener Pastures? Multinationals and the Pollution Haven Hypothesis*, Working Paper 1744 (World Bank, 1997).

<sup>19</sup> J. Clapp, 'Foreign Direct Investment in Hazardous Factories to Developing Nations: Rethinking the Debate', 7:4 *Environmental Politics* (1998), 92.

Some private actors are now responding to their critics by not transplanting their operations to countries with weaker regulatory regimes. This is mainly a voluntary initiative with an incentive to boost their corporate images. Some home countries are now attempting to regulate company activity abroad. Moreover, the inefficiency of operating subsidiaries at varying, and ultimately lower, standards precludes such action. This might lead to a general trend to improve environmental performance irrespective of location, bringing in environmental sustainable technologies and management systems.<sup>21</sup>

## RACE TO THE BOTTOM

The race to the bottom is a subset of the pollution haven phenomena as it consists of a positive action by a government lowering environmental standards, which in turn brings in foreign investment. Pollution havens may be States that lower their standards but they may also be based on existing relative differences in environmental regulation between countries without any action by the host State. Empirical evidence appears to counter the race to the bottom theory. It is seen to be unlikely that States will deliberately lower their standards and thus act contrary to national interests.<sup>22</sup> Government efforts to regulate and enforce environmental laws can be restrained by a volume of institutional limitations characteristic in developing countries. Furthermore, the NIMBY ('not in my backyard') syndrome and local pressure challenging the lowering of environmental standards to attract investment also act as countervailing forces, although this

<sup>20</sup> Ibid. Many foreign firms have relocated their plants for highly polluting industries such as pesticides (DDT) and asbestos in China (see X. Guoming *et al.*, *The Interface Between Foreign Direct Investment and Environment: The Case of China* (UNCTAD, 1999), at 24, available at <[http://www.unctad-10.org/pdfs/preux\\_fdipaper3.en.pdf](http://www.unctad-10.org/pdfs/preux_fdipaper3.en.pdf)>). See also X. Youfou, *Study on China's Control Measures to the Transfer of Foreign Wastes and Pollution Intensive Industries Through Trade and Investment* (unpublished paper, 1995) which records that over 36% of FDI in China was invested in highly polluting industries such as printing, dyeing and the electroplating industries. Other instances of industrial flight of heavily polluting sectors have been found in the case of asbestos tile and benzedrine dye manufacturing facilities relocating to Mexico and Romania (see F. Cairncross, 'Cleaning Up (A Survey of Industry and the Environment)', *The Economist* (8 September 1990), at 24) and the wet processing in the tanning industry from Europe to Brazil. See also N. Mabey and R. McNally, n. 10 above.

<sup>21</sup> E.B. Weiss, 'Environmentally Sustainable Competitiveness: A Comment', 102 *Yale Law Journal* (1993), 2123. See also L. Zarsky, 'Havens, Halos and Spaghetti: Untangling the Evidence about FDI and the Environment', in OECD, *Foreign Direct Investment and the Environment* (OECD, 1999), who cautions that such technology transfer may result in more intensive levels of production or other harmful activities.

<sup>22</sup> R. Revesz, 'Rehabilitating Interstate Competition: Rethinking the "Race to the Bottom" Rational for Federal Environmental Regulation', 8:2 *Journal of Env't and Dvlpmnt* (1992), 133.

can vary depending on the education, awareness and income levels of the community.<sup>23</sup>

However, the race to the bottom may exist in certain sectors. For instance, the natural resources sector, where developing countries often have limited regulatory experience, has a strong presence of foreign investors. In Zimbabwe, a country with dominance in the mining sector by foreign enterprises, the Mines and Minerals Act<sup>24</sup> supersedes all other legislation including statutes governing the protection of the environment. Similar experiences in the level of enforcement in the mining sector was seen in Papua New Guinea and Indonesia.<sup>25</sup> However, there are indications that most multinational mining enterprises apply equal standards to all of their operations, which may be stricter standards than those at the national level of many host countries.<sup>26</sup>

Overall government policy is geared towards attracting investment. Improving environmental regulation may only serve a part of the general effort to render the entry of investment more efficient. In Canada, as well as Germany, governments have streamlined their environmental laws or relaxed enforcement in order to implement the government's policy to present an attractive business-friendly climate for investors.<sup>27</sup> However, environmental policies only form a small part of the overall government strategy to create a business-friendly environment for investors and therefore these examples cannot represent strong affirmation of the race to the bottom hypothesis

The 'race to the bottom' theory may be evident in export processing zones developed solely for foreign investors to take advantage of a special legal regime geared towards export-oriented production.<sup>28</sup> Export processing zones (EPZs) are defined as specified areas where different sets of policy instruments apply that are not generally applicable to other parts of a country.<sup>29</sup> Governments provide various incentives to investors to locate in EPZs,<sup>30</sup> which are usually placed on a country's frontier due to its purported primary production for exports markets. For instance, the maquiladora region along the northern Mexican fron-

tier experienced a huge influx of economic activity in order to supply goods for US markets. Companies are exempted from the national domestic ownership requirements, as well as duty free imports, as long as a certain proportion of the output is re-exported.<sup>31</sup> The maquiladora and other free trade/EPZs usually do not have general exemptions of environmental or labour laws, but more a loosening of legal requirements relating to taxes, tariffs and the institution of duty free status. There is evidence of environmental decline in EPZ regions, although EPZs do not always lead to that result.<sup>32</sup> A World Bank study concluded that EPZ environmental regulation and performance is usually above the level applied for domestic industries.<sup>33</sup>

## RACE TO THE TOP

This is a countering theory to the 'pollution haven' and 'race to the bottom' hypotheses. It is expressed under the 'Porter hypothesis', which postulates that stronger environmental policies can improve competitiveness in the marketplace by fostering innovation and efficiency, therefore attracting investors. This is also termed the 'pollution halo' phenomena or the 'California effect' (where higher air standards in California led to other US States adopting similar levels).<sup>34</sup> However, the theory cannot be universally applied. It is premised on whether: domestic political or economic pressures in a 'green' country targets the environmental practices of a particular sector in a less 'green' country; the country with production aspires to enter into free trade agreements with industrialized countries such as the EU or USA; or the production process is covered by an effectively enforced multilateral environmental agreement (MEA).<sup>35</sup> Another weakness about the 'race to the top' theory is that it occurs mainly in high technology and energy-intensive sectors.<sup>36</sup>

A large motivator for raising environmental standards is the opening of foreign markets where higher levels of protection exist for domestic production. Market access can be closed to importers who produce under a looser regulatory regime, despite its potential inconsistency

<sup>23</sup> See L. Zarsky, n. 21 above, at 61.

<sup>24</sup> (1961) C. 165 as amended.

<sup>25</sup> N. Mabey and R. McNally, n. 10 above, at 36–37; World Wildlife Fund, *Foreign Investment in the Asia Pacific Mining Sector: National Policies, Economic Liberalization and Environmental and Social Effects* (WWF, 1999).

<sup>26</sup> See UNCTAD, n. 1 above, at 47.

<sup>27</sup> D.C. Esty and D. Geradin, n. 4 above, at 8.

<sup>28</sup> W. Ge, *The Dynamics of Export Processing Zones* (UNCTAD Discussion Papers, 1999). Ge notes that recent estimates have shown that there are more than 850 EPZs throughout the world.

<sup>29</sup> *Ibid.*

<sup>30</sup> *Ibid.* Ge notes that such incentives include: tax holidays; duty free status; simplified administrative procedures; fewer regulations; improved infrastructure and facilities; and advantageous geographical locations.

<sup>31</sup> A.B. Jaffe *et al.*, 'Environmental Regulation and the Competitiveness of US Manufacturing: What Does the Evidence Tell Us?', 33 *J. Econ. Lit.* (1995), 132.

<sup>32</sup> A study of Malaysian EPZs notes that there were positive impacts on the environment due mainly to the organized manner of the Malaysian regulations in accordance with zoning and building regulations. See G. Sivalingam, *The Economic and Social Impact of Export Processing Zones: The Case of Malaysia*, ILO Working Paper 66 (ILO, 1994).

<sup>33</sup> World Bank, *Export Processing Zones* (World Bank, Industry and Development Division, 1992).

<sup>34</sup> D. Vogel, *Trading Up: Consumer and Environmental Regulation in the Global Economy* (Harvard University Press, 1995).

<sup>35</sup> D. Vogel, 'Environmental Protection and Economic Integration', 3:2 *J. of Int Eco Law* (2000), 265.

<sup>36</sup> See N. Mabey and R. McNally, n. 10 above, at 43.

with World Trade Organization (WTO) rules. Private actors may pre-empt a possible dispute, considering the length of time involved in bringing a complaint to the WTO, by petitioning their law makers to promulgate higher standards.<sup>37</sup> Japan adopted US car emissions standards,<sup>38</sup> while Korea upgraded its car pollution abatement regulations in order to enter EU and US markets.<sup>39</sup> In Chile, the pulp and paper industry voluntarily decreased the amount of its chlorine bleaching largely in response to export market pressures.<sup>40</sup>

## REGULATORY CHILL

The concept of 'regulatory chill' can be best described where countries refrain from enacting stricter environmental standards in response to fears of losing a competitive edge against other countries in obtaining FDI. As a result, environmental regulations can get 'stuck in the mud'.<sup>41</sup> However, for developing countries with little or no environmental regulations, the phenomena can be better understood as the 'stuck at the bottom effect'.<sup>42</sup>

Although this is the most likely scenario when government policy is vetted by the need to bring in investment, it remains the most difficult to prove. Government inaction attributed to this reason is almost impossible to demonstrate. However, various efforts to impose carbon taxes in both the USA and the EU were occluded by concerns that it would render their industries less competitive.<sup>43</sup> The US Government's introduction of an energy tax in the early 1990s was ultimately terminated partly in response to criticisms from several energy and oil lobbies, claiming that the tax would reduce their competitiveness, cause massive job losses and encourage a flight of capital.<sup>44</sup> The introduction of the EU carbon tax was contingent on other Organization for Economic Cooperation and Development (OECD) member countries having a similar tax or measure exacting an equivalent financial impact.

Regulatory chill has also been observed in developing countries. It might be expected that this may be more commonplace since the impact of investor migration or outsourcing of production could be grave for overall economic development.<sup>45</sup> In Brazil, tanneries are caught between their inability to compete with better quality competitors in Europe and the lower cost producers from Asia. This has resulted in local governments being unwilling to enforce stringent regulations out of concern for losing employment and tax revenue.<sup>46</sup> Moroccan and Tunisian governments have shown reluctance to upgrade the level of regulation of the phosphate industry in response to the possibility that these companies may flee to countries having lesser environmentally regulatory scope.<sup>47</sup>

The cases determined by arbitration tribunals under Chapter 11 of the North American Free Trade Agreement (NAFTA) aptly point out that investors may use arbitration as a way to forestall government efforts to regulate the environment in a way that impacts their investment. The term 'investor' is given a wide application in NAFTA – any person/company who makes an investment in another NAFTA party.<sup>48</sup> An investment includes what is traditionally considered FDI as well as all types of financial investments, shareholdings and secured debts. In the *S.D. Myers* dispute, the opening of an office to service potential Canadian clients wishing to export polychlorinated biphenyl (PCBs), was ruled to be an investment.<sup>49</sup> Market share in a sector and access to markets in host States can be considered to be an investment despite no physical presence in the host State.<sup>50</sup> Protection can be afforded to investors who do not provide any capital investment or generate any local economic or employment benefits.

Measures that can be challenged (although not defined under Chapter 11 of NAFTA) encompass laws adopted by national, State or provincial legislatures, and regulations implementing laws. Local or municipal laws and by-laws can also be subject to investor/State arbitration, assuaging a much larger concern for investors since pollution control regulations are

<sup>37</sup> The time frame beginning with the date of establishing a panel to the date of implementing recommendations concerning a panel ruling is 18 months. See Understanding on Rules and Procedures for the Settlement of Disputes, WTO Agreement (Marrakesh, 15 April 1994), Annex 2, Articles 11, 17.5, and 20, printed in 33 ILM (1994), 1226.

<sup>38</sup> See D. Vogel, n. 35 above, at 273.

<sup>39</sup> Korea also was concerned about its exports being denied access to the Japanese markets. See D. Lee, 'The Effect of Environmental Regulations on Trade: Cases of Korea's new Environmental Laws', 5 *Georgetown Int Env Review* (1993), 659.

<sup>40</sup> See UNCTAD, n. 1 above.

<sup>41</sup> See N. Mabey and R. McNally, n. 10 above, at 39; and see L. Zarsky, n. 21 above, at 55.

<sup>42</sup> See C. Porter, n. 5 above.

<sup>43</sup> See D.C. Esty and D. Geradin, n. 4 above.

<sup>44</sup> D. Erlanson, 'The BTU Tax Experience: What Happened and Why it Happened', 12:1 *Pace Environmental Law Review* (1994), 173.

<sup>45</sup> Albrecht completed a survey of 107 countries which indicated that the greater the country's export diversification, the less a chance of regulatory chill. J. Albrecht, 'Environmental Regulation, Comparative Advantage and the Porter Hypothesis', *Note di Lavoro*, Working Paper 59.98, (Fondazione Eni Enrico Mattei, 1998), available at <[http://feem.it/web/activ/\\_wp.html](http://feem.it/web/activ/_wp.html)>.

<sup>46</sup> See N. Mabey and R. McNally, n. 10 above, at 33.

<sup>47</sup> *Ibid.*, at 34.

<sup>48</sup> NAFTA, Article 1101(1).

<sup>49</sup> *S.D. Myers Inc. v. Government of Canada*, 40:6 ILM (2000), 1408.

<sup>50</sup> The interim award in the *Pope & Talbot Inc. v. Canada* (NAFTA Arbitration Panel) (26 June 2000), ruled that access to the US market for a foreign investment is a property interest subject to protection under Article 1110 of NAFTA.

site-specific and therefore subject to local regulation.<sup>51</sup> In essence, all policies, requirements and practices affecting government interaction with businesses are potentially under challenge. This reveals evidence of regulatory chill on the enactment of new environmental regulations.<sup>52</sup>

A government's ability, within the exercise of its sovereignty, to regulate the environment and natural resources is matched against governmental obligations to protect foreign investors, and provide fair and equitable treatment. Effectively, a private/State investor dispute mechanism is usually discharged to rule on public welfare concerns. The NAFTA Arbitration Panel's decision in *Metalclad* went one step further, ruling on the constitutional validity of a local law in Mexico.<sup>53</sup> In these situations, the minimum standard of treatment of 'in accordance with international law' as set out in Article 1105 of NAFTA<sup>54</sup> lacks clarity and therefore cannot be accounted for when drafting laws.<sup>55</sup> Cognisant of potential litigation, State regulators may operate under a regulatory chill. The resort to Chapter 11 of NAFTA, without needing to exhaust local remedies, places foreign investors in an arguably more favourable position in contrast to local investors, who must appear before national courts that may have greater familiarity with the statutory and policy premises of government regulatory action.

## NEW ERA OF INVESTOR PROTECTION

Investor protection has evolved significantly, contributing to fears that evidence demonstrating the aforementioned theories will continue to appear. This has moved away from the era of accorded sympathy to developing countries aiming to nationalize their economies and lessen their dependence on foreign capital. The concept of expropriation has developed so that

government efforts to generally regulate the environment and other aspects of the economy are subject to arbitration since they could be seen as measures 'tantamount to expropriation'.<sup>56</sup> Expropriation, and in return compensation, would result where the investor's property was physically taken. Regulatory takings do not require a change in ownership but will arise where there is an impact on an economic interest.<sup>57</sup> This form of creeping expropriation recognizes that government activity might establish an environment where an investor can no longer effectively operate in the host country.<sup>58</sup> Legal title is not taken from the investor but the value of the property is diminished.

Cases under Chapter 11 of NAFTA reinforce the idea that States must now account specifically for the impacts of any measure on an investor. Some States may be wary of introducing a more restrictive regime for the purposes of environmental protection due to the potential financial liability from an investor challenge. An investor should expect some level of environmental regulation and management in response to either heightened environmental awareness or the discovery of new ecological problems, which must be internalized as a risk of the investment.<sup>59</sup> Having an option to challenge a new measure allows the investor to reallocate the risk to the regulator, and perhaps engage the polluter pays principle so that the general taxpayer bears the burden.<sup>60</sup>

The *Metalclad Case* involved an investor's claim that its investment was expropriated as a result of the refusal of the local government to grant a permit to operate a waste site.<sup>61</sup> (There was also a State ecological degree protecting the area.) The NAFTA Arbitration Panel ruled that this was a measure tantamount to expropriation. Expropriation was broadly defined to include covert or incidental interference with the use or future economic benefit of property. Therefore,

<sup>51</sup> NAFTA, Article 1101(1)(c). See also *Metalclad Corporation v. United Mexican States*, 40:1 ILM (2001), 35.

<sup>52</sup> A. Rugman, J. Kirton and J. Soloway, *Environmental Regulation and Corporate Strategy: A NAFTA Perspective* (Oxford University Press, 1999). See also, G. Horlick and A.L. Marti, 'NAFTA Chapter 11B: A Private Right of Action to Enforce Market Access through Investments', 14 *J. of Int. Arb* (1997), 43.

<sup>53</sup> See *Metalclad*, n. 51 above.

<sup>54</sup> Article 1105(1) of NAFTA reads: 'Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security'.

<sup>55</sup> The NAFTA Arbitration Panel in *Metalclad* ruled that the international law standard could be referenced from outside the scope of Chapter 11 of NAFTA. However, the panel in the *S.D. Myers Case* circumscribed the ambit of Article 1102 by narrowing the meaning of international law to custom and excluding what is present in other treaties. See *Metalclad*, n. 51 above; and see *S.D. Myers*, n. 49 above.

<sup>56</sup> See NAFTA, Article 1110.

<sup>57</sup> This developed from US case law, where a measure that deprived a landowner of all economically viable uses of land was considered to be expropriation. See *Lucas v. South Carolina Coastal Council*, (1992) 505 US 1003.

<sup>58</sup> However, the arbitration tribunal in the *S.D. Myers Case* rejected a claim of compensation for an export ban of PCBs, adding in *obiter dicta* that regulatory action does not necessarily constitute an expropriation. The substance of a measure and not just the form must be analysed, looking at whether the government benefits, whether there is a transfer of property, or whether there is an indirect benefit to others. See *S.D. Myers*, n. 49 above, at para. 285.

<sup>59</sup> Wäelde and Nidi note that the imposition of new regulations or judicial decisions is indeed a relevant consideration for investors. See T.W. Wäelde and G. Nidi, 'Stabilizing International Investment Commitments: International Law Versus Contract Interpretation', 31 *Tex. Int'l L. J.* (1996), 215, at 230.

<sup>60</sup> G. Verhoosel, 'Foreign Direct Investment and Legal Constraints on Domestic Environmental Policies: Striking a "Reasonable Balance" between Stability and Change', 29 *Law and Policy in International Business* (1999), 453, at 466.

<sup>61</sup> See *Metalclad*, n. 51 above.

local government decisions to protect the environment and ensure the welfare of citizens may be subject to investor challenges, undermining the basic police powers recognized in international law warranting an exemption to expropriation requirements.<sup>62</sup>

In addition to expropriation, investors under Chapter 11 can also impugn legislation or regulations that result in a denial of national treatment or fair or equitable treatment in accordance with international law.<sup>63</sup> This opens up new ground for investor challenges, regardless of the measure, as long as unequal treatment can be demonstrated. In the *Metalclad* dispute, the Mexican Government was found to have been in violation of Article 1105 due to: its failure to assure the investor that it would be in compliance with local and State laws; its failure to clarify the Mexican laws; and its failure to provide clear ways for investors to know the rules on how to obtain permits.<sup>64</sup>

## FDI AND THE FUTURE

The failed negotiations of the Multilateral Agreement on Investment (MAI) in 1998 left States without any agreed mechanisms to regulate FDI. Most favoured nation (MFN) status and national treatment requirements under the MAI would have been applied to foreign investments and created prescriptive rights of entry and establishment. In addition, a broad definition of expropriation was advanced. Although there are numerous reasons for its failure, part of the problem from an environmental standpoint was the fear that the MAI would restrict government power to regulate environmental resources or impose performance requirements ensuring environmental protection. The overall premise of the negotiations was that government power to control business needed to be contained.<sup>65</sup> Following the cessation of negotiations, it was expected that FDI discussions could move to the WTO under the auspices of the Agreement on Trade-Related Investment Measures (TRIMS) since it was the only current international forum where investment was being discussed.

Trade-related investment measures span a broad range of government activity. These can include: local

content rules; use of domestically produced products; local equity requirements on ownership; foreign exchange restrictions; and export/trade balancing requirements. Each of these is potentially trade distorting. Where they do have an impact on national treatment and MFN requirements, they can run afoul of international trade law rules.<sup>66</sup>

The TRIMS Agreement forms part of the trade instruments agreed to in the Uruguay Round. Its inclusion in the final WTO agreements was controversial as many developing countries were opposed to it. A compromise was reached so that only goods would be covered and that the trade-distorting effects of TRIMS and not the investment measures could be impugned. As a result, it is limited in scope. It is an international agreement among States and therefore has no direct effects on investors. Only measures that are included in the Agreement are regulated, with the remainder beyond the scope of TRIMS. There is an illustrative list of investment measures deemed to be inconsistent with WTO agreements (such as local content requirements and balance of trade measures). Measures at the sub-national level are exempted from the ambit of the TRIMS Agreement.

Negotiations on extending the TRIMS Agreement forms part of a 'Singapore issue'<sup>67</sup> in the Doha Development Round of WTO negotiations. Decisions on the modalities of the negotiations will be decided at the next ministerial meeting in Mexico, scheduled for 2003. The industrialized WTO members are seeking greater protection for their foreign investors in the face of performance requirements and other restrictions in host countries. The current agreement does not provide for a general progression towards investment liberalization and it appears that a new agreement would not speak to this objective. The Doha Declaration stipulates that an investment framework agreement should reflect interests of home and host countries, i.e. take into account development policies and objectives of host governments and the right to regulate in the public interest.<sup>68</sup>

Another factor that should not be dismissed is the rising number of Bilateral Investment Treaties (BITs), currently numbering at over 2000.<sup>69</sup> BITs are increasingly the source of investor/State disputes before arbitral tribunals at the International Centre for the

<sup>62</sup> See, for instance, the cases decided under the Iran-US Compensation Tribunal.

<sup>63</sup> NAFTA, Articles 1102 and 1105.

<sup>64</sup> The transparency requirements interpreted to fall under Article 1105 of NAFTA were ruled to be *ultra vires* of the arbitration panel in the review of the decision by the British Columbia Supreme Court in *The United Mexican States v. Metalclad Corporation*, (2001) BCLR 664 (BCSC).

<sup>65</sup> P. Muchlinski, 'The Rise and Fall of the Multilateral Agreement on Investment: Where Now', 34:3 *International Lawyer* (2000), 1033.

<sup>66</sup> See *Canada - Foreign Investment Review Act*, BISD 30S/140 (1984).

<sup>67</sup> Investment, alongside government procurement and competition, are labelled 'Singapore issues' since they were raised at the Singapore WTO Ministerial in 1996.

<sup>68</sup> Ministerial Declaration (Doha, 14 November 2001), available at <[http://www.wto.org/english/thewto\\_e/minist\\_e/min01\\_e/mindecl\\_e.htm](http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm)>.

<sup>69</sup> L.E. Peterson, 'International Investment Rules: Is the GATS Campaign Becoming a Red Herring', 6:3 *Bridges* (2002), 17.

Settlement of Investment Disputes (ICSID) and the International Chamber of Commerce (ICC). This is placing the heart of government decision making under the microscope of international arbitration – a process that is held *in camera* without any proscribed obligations for public disclosure. In February 2002, Aguas del Tunari (a private Bolivian water company) and Bolivia submitted a dispute to ICSID under the terms of a bilateral investment treaty between Holland and Bolivia. The dispute concerns Bolivia's decision to repatriate its water service utility after members of the Bolivian population raised strong objections. The existence of protective clauses for investments, as well as broad rights of entry and establishment, in BITs may be another factor dampening the enthusiasm for any furtherance of TRIMS.

The legacies of both the MAI debacle and the implications of Chapter 11 of NAFTA have watered down the enthusiasm of taking TRIMS any further. The incapability of balancing public and private interests and the perceived insensitivity of the WTO to the social, environmental and development dimensions, fuel the opposition.

## CONCLUSIONS

Most of the comprehensive surveys on FDI counter the various hypotheses mentioned in this article. Private investors usually do not include environmental

regulation as a substantial factor when deciding on the locations of their investments. Evidence on whether host countries positively alter their environmental regulatory system to attract FDI is not consistent, and perhaps limited by the lack of availability of information from host countries. However, there is still concern that environmental laws and their enforcement may be subject to pressure to attract foreign investment. Where environmental management is paramount to a business operation, the need to provide economic development may lessen the priority of environmental protection. The absence of any significant international agreement on investment, or the conduct of foreign investment, may lead to further instances of investors taking advantage of lower standards. The overall trends do not dismiss individual examples of this. Some treaties and national laws speak to the race to the bottom, enjoining countries from lowering their environmental standards for the purpose of encouraging investment.<sup>70</sup> In turn, bilateral and multilateral investment may be the most judicious and effective way to prevent States from deliberately disregarding their commitments to environmental protection (in order to lure foreign investors) by providing the legal bases to challenge governments who do this.

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<sup>70</sup> NAFTA, Article 1114(2). This recognizes that it is inappropriate for parties to lower health or environmental standards to attract foreign investment. However, violations of that provision are not subject to dispute settlement and only give rise to obligations to consult. See also the US Clean Air Act, which prescribes minimum standards so as to avoid distortions in competition. See D.C. Esty and D. Geradin, n. 4 above, at 15; see also P.R. Portney, 'Economics and the Clean Air Act', 4:4 *J. of Econ. Perspectives* (1990), 173.