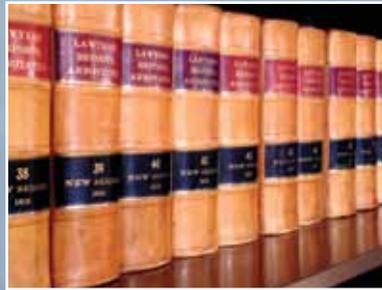


Investment Law Reform

A Handbook for Development Practitioners



Investment Climate Advisory Services | World Bank Group



With funding from FIAS, the multi-donor investment climate advisory service

in partnership with 

INVESTMENT LAW REFORM

A HANDBOOK FOR DEVELOPMENT PRACTITIONERS

INVESTMENT CLIMATE ADVISORY SERVICES OF THE WORLD BANK GROUP

June 2010



in partnership with



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LIST OF ACRONYMS

BIT	Bilateral Investment Treaty
BP	British Petroleum
CAFTA	Central American Free Trade Agreement
CAFTA-DR	Central American Free Trade Agreement – Dominican Republic
CATIC	China National Aero-Technology
CEMAC	Communauté Economique et Monétaire de l’Afrique Centrale
CIT	Corporate Income Tax
CFIUS	Committee on Foreign Investment in the United States
DPW	Dubai Port World
ECT	Energy Charter Treaty
EPZ	Export Processing Zone
EU	European Union
FDI	Foreign Direct Investment
FET	Fair and Equitable Treatment
FTA	Free Trade Agreement
FTC	Free Trade Commission (NAFTA)
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
IC	Investment Climate Advisory Services
ICC	International Chamber of Commerce
ICJ	International Court of Justice

ICSID	International Centre for Settlement of Investment Disputes
IFC	International Finance Corporation
IIA	International Investment Agreement
IMF	International Monetary Fund
IPI	Investment Promotion Intermediary
ISPAT	Investment Support and Promotion Agency for Turkey
LCIA	London Court of International Arbitration
M&E	Monitoring and Evaluation
MFN	Most Favored Nation
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
OEPC	Occidental Exploration and Production Company
OSS	One-Stop Shop
PEP	Private Enterprise Partnership
P&O	British Peninsula and Oriental Steam Navigation Company
R&D	Research and Development
REIO	Regional Economic Integration Organizations
SCC	Stockholm Chamber of Commerce
SME	Small and Medium-size Enterprises
TNCs	Transnational Corporations
TRIMs	Trade-Related Investment Measures
UNCTAD	United Nations Conference on Trade and Development
UNCITRAL	United Nations Commission on International Trade Law
URA	Uganda Revenue Authority
VAT	Value-added Tax
WBG	World Bank Group, comprising the World Bank (International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA)), the International Centre for the Settlement of Investment Disputes (ICSID), the International Finance Corporation (IFC), and the Multi lateral Investment Guarantee Agency (MIGA)
WTO	World Trade Organization



PREFACE

Laws evolve as societies do. To be relevant and effective, laws have to keep pace with global changes and with changes within the particular societies to which they apply. Investment laws are no exception. This “Handbook on Investment Law,” a welcome contribution prepared by the World Bank Group, shows the evolution of the field, some 20 years after the publication of the “Legal Treatment of Foreign Investment: World Bank Guidelines,” developed by the late Ibrahim Shihata, and published in 1993. Since the early 1990s, norms and standards of, and investors’ expectations from, investment climates have evolved around the world. The present handbook, written for policymakers, advisors, and practitioners, captures many of those changes and weaves them within guidelines based on well-tested good practices seen across economies at different levels of development over the last few decades.

One of the major structural changes is the coverage of both domestic and foreign direct investment (FDI) policies in one investment law. This is not surprising when one considers that the investment regimes for domestic and foreign investment,

separate and distinct in most countries over decades, have been converging in recent years. The nature, scope, and level of sophistication of guarantees to investors have also evolved in recent years. Finally, until the recent financial and economic crises, the overall majority of economies expanded the openness of their economy to FDI, to the point where, to be more practical and investor friendly, “negative lists” – short lists of sectors in which foreign investment is regulated or prohibited – have been replacing “positive lists” – lists of sectors open to FDI.

These three illustrations of the evolution of investment laws are a small, partial reflection of the evolution of investment policies and investment climate. Indeed, investment laws and their implementing regulations are but the tip of the investment climate iceberg. There are many definitions to investment climate. Irrespective of how inclusive or minimalist a definition is, it encompasses the factor endowment of an economy; its physical and institutional infrastructure of relevance to investment, including its legal system; and various socioeconomic policies, particularly its

investment policy, whether explicit or not. Investment policies reflect what governments seek from investment for the purpose of meeting national objectives, as well as the rights and responsibilities they assigned to investors and investment. An investment law and its regulations are respectively the codification and administrative implementation of the national investment policy. It is therefore important that the investment policy and its corresponding investment law stay in harmony. When the policy experiences a substantive change, it is good practice for a government to amend or rewrite the investment law accordingly, lest that harmony is broken to the detriment of the national welfare and of investors.

Investment laws are not necessarily the most important laws in a country nor are they high in the hierarchy of laws within a national legal framework. In addition, the overall majority of OECD countries do not have investment laws, yet they attract the lion's share of FDI. So why give importance to investment laws? From an economic development point of view, investment laws carry their importance on two levels. First, they contribute to the quality and characteristics of the investment climate because they are part of the development and expression of a national investment policy package. They are also a focal point for the expression of the authorities' expectations from, and treatment of, investors. Second, unlike in OECD countries, developing countries' economic and legal frameworks are still in various stages of development, and public and private institutions are still maturing. So investment laws are crucial in that they provide in one place a succinct coverage of much of the investment policy of a country and its legal underpinning, as well as a signal that the government is welcoming investment. They help frame the conditions under which a country wishes to attract FDI, FDI being an important source of technology, finance, and know-how, and an avenue to access foreign markets.

Past attempts at developing a universal model investment law have failed miserably. This is not surprising. While they need to be in line with global trends and expectations of foreign investors whose investment domain is theoretically the world, investment laws have also to reflect fundamental characteristics of the country, including its economic priorities, culture, legal system, and stage of its social and economic development. On the basis of good experiences of many countries over the last few decades, guiding principles for good investment laws have been drawn. This handbook emphasizes those guiding principles, recognizes the possibility of using them under different conditions and, as illustration, offers various options for good practice.

Whether policymakers or advisors are looking for guidelines about what should go into an investment law or what policy options they may wish to adopt to follow good practice, or law drafters are seeking support for a way to craft a clause effectively, they will all find the handbook very useful. Their challenge is to produce an investment law that is faithful to their national priorities and reflects the characteristics of their country, and at the same time that meets international standards to be attractive to investors, whether domestic or foreign. They will find the handbook highly useful in meeting that challenge.

Joseph Battat

Former Manager of the
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World Bank Group



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INTRODUCTION

Focus

Investor survey after investor survey, study after study, identifies a country's legal framework as a key component of its investment climate and thus of its attractiveness for private investors, domestic and foreign.

The legal framework is not the only or most important component; the political environment, macroeconomic conditions, physical and institutional infrastructure, and quality of economic and tax policies, regulatory processes, and labor market, to name but a few other components, all play a role in making a country more or less attractive.

While the Investment Climate Advisory Services (IC) of the World Bank Group (WBG) provides expert advice and technical assistance to governments around the world on many of these components, this handbook focuses on one element of the legal framework for investment: investment legislation.

More specifically, it deals with creating new and reforming existing investment legislation in developing and transition economies in furtherance of the WBG's mandate to promote private investment – domestic and foreign – in those economies.

Handbook appendices contain drafting guidelines and checklist of issues that FDI laws should include and that countries can use when drafting investment legislation. While including an model investment law might seem useful, we opted not to do so for the following reasons:

- A country's investment law should reflect its investment policy, its current laws, and so forth. Presenting a model law would create the risk that the country (or the drafters of its legislation) would use the model without adapting it to the country context, which might result in failure.

- Previous attempts to present a model investment law were not successful. Some countries have an investment law that covers both foreign and domestic investment, whereas other countries choose to cover only foreign direct investment (FDI). This would necessitate the development of two model laws.

Goal and Target Users

The chief purpose of this handbook is to provide government lawyers with a framework to evaluate the quality of a country's investment legislation (if it exists) and how the legislation relates to its investment policy and investment incentives. It also provides practical guidance on how to write new or reform existing investment legislation based on emerging "good practices." Although the starting point for each process is different, the same principles and objectives apply to both.

Depending on their respective responsibilities and needs, different readers will find what they need in the handbook. While a government official may only want to better understand the link between investment policy, law, and incentives, a legal drafter or ministry team tasked with drafting legislation will need the more detailed information, for instance, the drafting guidelines. Staff in the WBG or other donor agencies who work on private sector development might not need to know much about an individual investor's rights or guarantees, but they do need to know how to design an investment legislation reform project in a client country. The project cycle and monitoring and evaluation chapters might be more useful to WBG staff than they are to government legal drafting team. This handbook provides such information and guidance.

Methodology

Consistent with its goal and target users, the handbook is designed to be a practical tool, not an academic treatise. By simplifying underlying concepts and terminology of investment law, most sections of the handbook are accessible to nonlawyers. That said, law is a complex, technical topic, and some sections discuss intricate legal issues that are more appropriately left to the lawyers in our audience.

Most of the data and information used in the handbook come from the 20 years of experience that IC has gained in advising governments in developing countries on how to reform their investment policy and legislation and from extensive data it has collected on the various aspects of the legal framework for investment. This experience is complemented by research conducted by the WBG team and discussion held with outside lawyers.

Content

Chapter 1 defines key terms about investment law reform in an effort to clarify terminology and concepts and show how they are related.

- First, the chapter looks at *investment climate*, *investment policy*, and *investment legislation* so that readers understand why governments should enact better investment legislation. Legislation is the key tool for implementing investment policy, and investment policy is a core element of the country's investment climate – at some point, a country that wants to adopt a more liberal investment policy to make its investment climate more attractive will have to review its investment legislation. One has to understand the relationship between these three notions and what is considered a

“conducive investment policy” if one is to prepare good practice investment legislation.

- Second it discusses international law vs. domestic law.
- Third, it discusses the typology of investments: *public v. private, direct v. portfolio, domestic v. foreign investment*. This is important because investment codes usually cover only private investment (not public or portfolio) and some codes cover only foreign, not domestic investment.

Chapter 2 examines how widespread investment codes are and explains their utility and limitations.

Chapter 3 provides recommendations on the structure of investment legislation and the key provisions to be included such as definitions, investor guarantees, incentives, framework for investment promotion, and transitional provisions. This chapter also discusses the particularities of the preparation of an investment code in a subnational context and in conflict-affected areas.

Chapter 4 discusses the fundamental issue of investor entry, in particular the conditions under which foreign investors can invest including sectoral restrictions, limitations on foreign ownership, authorization and screening, minimum investment and performance requirements. In many countries, burdensome investor entry procedures can constitute a significant barrier to investment.

Chapter 5 discusses key investor guarantees including fair and equitable treatment, national treatment, most-favored-nation (MFN) treatment, protection against expropriation, guaranteed

convertibility and repatriation of profits, and settlement of disputes.

Chapter 6 looks at the issue of investment incentives, (fiscal incentives in particular) and their effectiveness. It does not attempt to cover this complex and sensitive issue in detail but it does touch upon this component of many current investment laws – even though incentives more rightly belong in tax and customs legislation.

Chapter 7 summarizes key aspects of investment promotion to guide legal drafters, should policy-makers want the investment code to set out the basic framework of investment promotion. The chapter also addresses the alternative approach of writing separate legislation to establish an investment promotion intermediary (IPI).

Chapter 8 presents the various phases of investment law reform projects, from the government’s request for assistance with legislation to the delivery of a project plan. The steps include evaluating the government’s request to determine the degree of engagement (from a simple desk review, to medium- and large-scale projects) as well as the pre-field and field research.

Chapter 9 identifies some of the challenges in preparing an investment code and the support that governments may need until the law is promulgated. Issues discussed in this chapter include how to make the case for reform for stakeholders and how to support the reform effort through smart use of communication.

Chapter 10 discusses the monitoring and evaluation (M&E) of investment law reforms, including the key indicators involved in a desk review and medium- and large-scale projects.



CHAPTER 1: KEY NOTIONS AND TYPOLOGY OF INVESTMENT

Investment Climate and Investment Policy

Investment Climate

A host of interacting factors determine the quality of a country's investment climate. They include the macroeconomic policy framework, trade policy, taxation, foreign exchange, land and labor; political risk and governance; government administration and management of the regulatory process related to commercial activities; legal and judicial frameworks and their ability to protect property, settle disputes, and enforce contracts; and the quality of both the physical infrastructure – power, transportation, and water – and institutional infrastructure – educational and banking systems and civil society institutions.

Different investors will have different views on the relative importance of these components of the investment climate, but, generally speaking, they are all important. A country needs to make sure that each component works well and that together they form a coherent system that will attract

investment, domestic and foreign, while preserving legitimate national interests.

This handbook focuses on one component of the investment climate, the legal framework for private sector development and, within that framework, investment legislation. It does not cover the many other types of legislation that a country needs, their quality, or the judicial enforcement of laws.

Investment Policy

A country's investment code cannot be drafted out of context – it must reflect its investment policy. In fact, the code is the legislative instrument for implementing the policy.

Too many countries put “the cart before the horse”: Often a government minister asks a lawyer within or outside the government, to draft a “good” investment code, without underlying policy guidance. This usually leads to disappointing results. Drafters of legislation cannot make policy and should not be asked to do so.

Instead, before asking lawyers to draft a new investment code or revise the existing one, a government needs to formulate its investment policy: How open does the country want to be to private investment, particularly foreign investment? Will foreign investment be allowed in all economic sectors or only in some of them? These critical questions are not “legal” issues; they are, however, prerequisites to any effort to draft or revise an investment code. Appendix 1, Guidance Note on Preparing an Investment Policy Statement, discusses this issue at greater length.

Once a government has determined how open or, in contrast, how restrictive it wants to be, lawyers can draft the legislation, putting the policy into legal language.

What important policy questions should a government address?

The policy questions can be formulated in relatively simple terms, at least on the surface. Essentially, they have to do with **who can invest** in the country, **where**, and under **what conditions**. (See Box 1 for illustrative questions that policymakers should answer.) The answers, of course, can be more complicated, especially those pertaining to foreign investment. This is consistently the most sensitive issue that policymakers and, hence, legal drafters face.

Once a government has formulated its overall investment policy or strategy based on issues such as the degree of openness and control or facilitation it wants to put in place, it has to implement the policy. Investment legislation “translates” the policy into legal terms that are actionable including in a court of law. If the policy is not clear, however, these issues will resurface and hamper the law-making process.

It also should be noted that policy (and therefore legislation) is not a static principle, “carved in stone,” but a dynamic element that evolves with the country’s political and economic circumstances. Over time, a country may shift:

Box 1. Fundamental Investment Policy Questions for Policymakers

- How open does the government want to be to private investment and particularly to foreign investment?
 - Where can an investor invest – in all economic sectors or just in certain sectors in which the government wants more competition?
 - Which sectors are to be reserved for national (private or public) investment? Why?
 - Will a foreign investor be allowed to own 100 percent of a project or only a certain percentage? Why?
 - How will foreign investors invest? Will the investment have to be screened or be automatic?
 - What will be foreign investors’ rights? Will they be treated like domestic investors? In all respects?
 - Will foreign investors be able to transfer their profits and capital overseas?
 - Would investors’ projects be susceptible to expropriation? If so, under what conditions?
 - What incentives instruments, if any, will the government use to promote domestic and foreign investment into the economy? How is this consistent with the tax policy?
 - Will the government put in place a special agency to deal with investors? All investors or only foreign investors?
-
- From a restrictive investment policy (and legislation), with a government ideologically averse to foreign or all private investment that erects myriad and fragmented controls, prohibitions, and restrictions,
 - To a “liberal,” or more “open” investment policy (and legislation), the result of a change in government, in economic conditions, or when the government considers such policy suitable for its economic strategy and development and wants to encourage economic growth.

The policy change can be gradual or more rapid, depending on the country circumstances.

Many developing and transitioning countries have already made this shift toward facilitation and openness. With policies that provide investors greater legal security predictability and transparency and fewer restrictions, the countries actually compete against each other to promote and facilitate investment.

Rationale for Investment Policy Openness

We have noted that investment policy drives investment legislation (and not the other way around). We need to answer another question: Why should developing countries reform their investment policy, particularly with respect to foreign investment?

In today's globalized economy, a growing number of developing and transition countries have come to realize the benefits that can be derived from private investment, including foreign investment, for economic growth and poverty alleviation.

In a country with insufficient domestic investment, foreign investment can provide much needed resources through injection of new capital, transfer of technology and know-how, job creation, increased market access, strengthening of the local private sector through backward linkages, and so forth. Box 2 summarizes the main benefits of private and foreign investment for an economy.

Good Policies, a Necessary but not Sufficient Ingredient

It is important to note here that good policies are necessary but not sufficient to automatically guarantee increased flows of private investment. In the area of FDI for instance, the United Nations Conference on Trade and Development (UNCTAD) states:

“To attract FDI and benefit from it, Governments

Box 2. Benefits of Private and Foreign Investment for a Country's Economy

Private capital deployed in a country provides many potential benefits to the recipient economy. In particular it can:

- Allow the reallocation of public resources to other needs
- Create employment through new or expanded projects
- Generate tax revenues (in the absence of tax holidays)
- Provide the domestic labor force with new skills and training
- Improve local management skills (because the economics of expatriate labor creates an incentive for the utilization of local managers)
- Provide new technology and know-how transfer
- Accelerate the rate of infrastructure development

take a range of measures. One of the first things Governments wishing to attract FDI can do (and should do) is to establish an enabling policy framework for FDI. Of course, they need to recognize that the FDI policy framework is but one of the factors that attract FDI inflows. It is a necessary but not a sufficient condition to influence locational decision. Business facilitation measures –the efficiency and efficacy of the administrative system that impinges on the entry and operations of TNCs (transnational corporations), as well as investment promotion (including incentives available to foreign investors) can also influence FDI inflows.” (UNCTAD 1999)

In other words, investment-friendly policies promote economic growth by providing a more secure and predictable environment in which one can invest in productive business activities.

Growth patterns of developing countries support the conclusion that facilitative policies serve to attract more and better investments. Based on this

recognition, developing and developed countries have increasingly moved toward introducing more open and “market or investor-friendly” policies and associated legislation, regulations, and administrative practices (UNCTAD 2003)

“Conducive” Investment Policies

Now that we have established that (i) investment policy formulation is a prerequisite to investment legislation drafting and that (ii) putting in place open investment policies can have a positive impact on economic development, we need to identify the key attributes of such “conducive” policies.

A conducive investment policy is designed to

attract and facilitate private investment in general and FDI in particular; it encourages domestic and foreign investors to invest in the country by raising the level of comfort and minimizing uncertainty, discretion, and ambiguities. A nonconductive policy environment, by definition, discourages investors by not providing the level of comfort they need to invest. This is true in any economy, developed or developing, but it is particularly relevant in a developing country, where investors have the perception that they are taking greater risks.

Box 3 lists the main determinants of investment including conducive policies.

Box 3. Determinants of Investment

Economic conditions	Market access	Size, income levels, urbanization, stability and growth prospects, access to regional markets, distribution and demand patterns
	Resources	Natural resources, location
	Competitiveness	Labor availability, costs, skills, trainability, managerial and technical skills, access to inputs, physical infrastructure, supplier base, technology support
Host-country policies	Macro policies	Management of crucial macro variables, ease of remittance, access to foreign exchange
	Private sector	Promotion of private ownership, clear and stable policies, easy entry/exit policies, efficient financial markets, other support
	Trade and industry	Trade strategy, regional integration and access to markets, ownership controls, competition policies, support for SMEs*
	FDI policies	Ease of entry, access to inputs, transparent and stable policies
Multinational enterprise strategies	Risk perception	Perceptions of country risk based on political factors, macro management, labor markets, policy stability
	Location, sourcing, integration transfer	Company strategies on location, sourcing of products /inputs, integration of affiliates, strategic alliances, training, technology

Source: Lall (1997).

Note: The fundamentals of attracting FDI can also be extended to attracting sustained domestic investment.

* SME=small and medium enterprises

Substantive Qualities of Conducive Policies

As stated above, conducive investment policies are those that support and enable private investment, including foreign investment. They ensure ease of market entry and exit and access to inputs investors need. They impose few restrictions on sectors in which investors can invest, how they can invest, and how much they can invest. Conducive policies also provide legal security to the investment project, the investors, and their assets.

None of these policies are inconsistent with the legitimate desire to regulate investment and economic activities to protect the environment, public health, consumers, or national security interests. Investors are subject to host-country laws; for example, the government can reject a project that would violate environmental law or negatively affect health. Nothing in this handbook suggests that there should be no governmental regulation or control over economic activities including investment. The suggestion is not “no regulation” but “better regulation.”

The following are features of a policy that is “conducive” to private/foreign investment:

Flexibility in Investor Entry

Several countries impose some restrictions on investment entry such as mandatory minimum capital requirement for investors and the requirement that a governmental institution screen any potential foreign investment. While sometimes serving the legitimate objective of ensuring high-quality investments, such qualifications tend to discourage private investment and unwittingly go against governments’ own stated policy of promoting domestic and foreign investment. Minimum capital requirements for investments are likely to dissuade valuable small investments, particularly those in noncapital-intensive businesses in the services sector.

In recognition however of the role of FDI in their

economies, several countries have eliminated various restrictions to FDI entry. Box 4 lists two examples of such reform in the East Africa region.

Although none of the world’s largest FDI recipients, which include Brazil, China, India, and Russia, has a completely open entry regime the ideal framework is a liberal entry regime that recognizes that there is little connection between the amount of capital invested and viable businesses that encourage innovation and that investment provides employment and government revenue through taxes paid.

Box 4. Relaxing Investment Entry Policy: Examples from East Africa

- The government of Tanzania has eliminated minimum capital requirements for FDI entry in general.*
- The government of Uganda has stopped requiring foreign investors to invest minimum amounts although it only offers the facilitation support of its Investment Authority when investment exceeds \$100,000 (soon to be revised to \$25,000 for both national and foreign investors).**

*However, Tanzania makes special incentives conditional upon holding an investment licence and investing a minimum of US\$300,000.

**UNCTAD and Japan Bank for International Cooperation (2005).

Investors’ Rights and Guarantees

Most investors expect a recipient country to guarantee them, at minimum, the rights and protections listed below. The government needs to first establish these guarantees as a matter of policy and then to seek implementation through legislation.

- **Nondiscrimination:** National or equal treatment of foreign and domestic investors,

without discrimination, is a good practice standard that encourages foreign investment and is a key characteristic of an open investment policy. It is usually articulated in constitutionally mandated equal treatment clauses that do not derogate from a country's need to provide special support for its citizens.

- **Right to ownership and security of investment:** All investors look for a guarantee against arbitrary nationalization, unlawful expropriation, or confiscation of their property, or any other governmental measure with similar effect. A guarantee of due process with prompt, adequate, and effective compensation in the event of expropriation of is widely viewed as best practice.
- **Convertibility and repatriation of capital and earnings:** Foreign investors will not consider a location without a clear guarantee that they will be able to freely convert and transfer profits, capital, and other proceeds of their enterprise (after they have fulfilled their host-country tax obligations).
- **Alternative dispute resolution mechanisms:** Many private investors want to have the option of utilizing alternative dispute settlement mechanisms to resolve their disputes with both private companies and the government. This is particularly true for foreign investors in developing or transitioning countries.
- **Expatriate Labor:** The issue of host-country facilitation of investment-related employment for foreigners while domestic unemployment is high is a difficult one that sometimes results in host-country regulations prohibiting or limiting employment of noncitizens. These regulations include requiring employers to provide justifications and meet preconditions such as proof of unavailability of local expertise.

While such rules respond to the legitimate interest of ensuring employment priority for citizens, a country should ensure that the rules do not discourage investors, particularly when critical human resources capacity is unavailable domestically.

Nonsubstantive Qualities of the Policies

“Nonsubstantive” does not mean unimportant. Rather, it refers to qualities that do not pertain to the “substance” of the policy. That is, they are not “content-specific.” (See Box 5.) The same qualities can in fact apply to other areas of economic policy (trade and taxation, for instance).

Therefore, in addition to the above-mentioned substantive aspects, good investment policies should have the following features: clarity, stability, and transparency. Ambiguous investment policies

Box 5. Features of Good Investment Policy

Investment policy should be:

- Transparent and publicly documented, so that any investor can readily ascertain where they can and cannot invest and under what conditions
- Simply stated, so that they can be easily understood by everyone
- Unambiguous, so that their meaning is indisputable
- Nondiscretionary, so that decisions are taken on objective criteria
- Comprehensive and complete, so that potential investors know the full situation and will not encounter “surprises”
- Stable and predictable, so that investors’ legitimate expectations will not be jeopardized by unforeseen policy changes
- Consistently applied, so that there is no uncertainty in the outcome from following them

Source: IC research

will produce ambiguous investment legislation, which will likely lead to disputes between the state and investors. Policy that is well written but that changes frequently generally makes investors unsure about investing. Policy that is not available, easily accessible, and transparent also discourages investment. Consistency and transparency must permeate all levels of government policy, from the highest-level cabinet policy to the lowest-level decree or individual decision made for an investor. The same qualitative features should be applied to investment legislation and administrative procedures.

As discussed below, some countries choose to adopt a single instrument, called an investment act or investment code. Other countries prefer to regulate investment through a number of distinct laws and regulations. Chapter 2 will discuss the advantages of having a special investment law.

International and Domestic Law

Should this handbook about domestic legislation to regulate investment be concerned with international law?

While an investment code is domestic legislation, foreign investment, with its cross-border flows of capital, residency issues, investor guarantees, and so forth, necessarily adds an international dimension to the topic.

Many international agreements on foreign investment are in force today. When investment legislation reform is considered, it is essential to take into account:

- A country's obligations at the international level, to avoid conflict and ensure consistency between the proposed national legislation and international instruments that supersede domestic legislation.

- International conventions established to ensure competition, even when a country is not a party to the agreements.

Box 6 lists examples of international conventions and agreements on investment and trade that a government should consider when revising its investment policy and legislation. Conventions on investment and trade provide a great degree of protection to foreign investors. If the country is already a signatory to these conventions, it is important that the government does not introduce into the investment code any provisions that may contradict the content or undermine the effect of these conventions. In certain countries and legal systems, international treaties validly signed and ratified prevail over domestic legislation. Governments should carefully check for the consistency of their domestic investment legislation with the international obligations they have undertaken by adhering to these international instruments.

Investment Typology

Public Investment v. Private Investment

There are many types of investment. To simplify, one can start by drawing a line between public and private investments, depending on whether the source of the investment is the government or the private sector.

A distinction should be made between public entities that operate as state entities and those that act on a commercial basis, operating like any business and competing with private sector entities. To simplify a complex status, which differs across jurisdictions, we will note here that the activities of the commercial "public" entities are often regarded and treated as private investment.

Although public investment is important for economic development, this handbook focuses on

Box 6. Examples of International Conventions and Agreements on Investment and Trade

Convention on the Settlement of Investment Disputes between States and Nationals of Other States, known as the Washington Convention (1965)

This convention has been adopted within the framework of the WBG. It establishes the International Centre for Settlement of Investment Disputes (ICSID), which facilitates the settlement of investment disputes through arbitration and conciliation.

World Trade Organization (WTO) Agreement on Trade-Related Investment Measures (TRIMs)

The TRIMs agreement aims keep at eliminating performance requirements that have trade restrictive and distorting effects. It prohibits any trade-related investment measure that is inconsistent with either the principle of national treatment or the principle of abolition of quantitative restrictions. It applies to all WTO members.

General Agreement on Trade in Services (GATS)

GATS relates directly to the regulation of foreign investments in services. It aims in particular at the liberalization of market access for services.

Regional agreements

Provisions on foreign investment also appear in several other regional agreements, involving the Association of Southeast Asian Nations (ASEAN), Southern Common Market (MERCOSUR), and African, Caribbean and Pacific Group of States (ACP)-European Union (EU) countries.

North American Free Trade Agreement (NAFTA)

Adopted in 1992 by Canada, Mexico, and the United States, NAFTA contains detailed provisions on the protection of foreign investment (Chapter 11, NAFTA). Other significant provisions ensure freedom of admission or establishment to investors of one party on the territory of another party, through the extension of the national treatment principle to the so-called “pre-establishment” phase.

Central American Free Trade Agreement (CAFTA), extended to the Dominican Republic (CAFTA-DR)

CAFTA's provisions are similar to those of NAFTA.

Energy Charter Treaty (ECT)

The ECT covers more than 50 European and Central Asian countries and contains a specific chapter on foreign investment.

Bilateral investment treaties (BITs)

Over 2,700 BITs have been concluded by countries all over the world.* The most extensive networks of BITs have been negotiated by Germany and China, with more than 100 BITs each. Over 600 BITs have been signed between developing countries. Standard BITs contain provisions on the admission and establishment of foreign investments, standards of treatment, expropriation or nationalization measures, transfer of income and capital, protection of investment agreements or contracts, guarantees granted to foreign investments by home state agencies, and dispute settlement mechanisms. Recent BITs are often more detailed, with provisions on senior management and entry of personnel, performance requirements (very few), monopolies and state enterprises, health, safety and environmental measures, taxation, and prudential measures and procedural details under the dispute settlement provisions. Such a global and dense network of bilateral treaties has inevitably had an impact on national investment laws.

Free trade agreements (FTAs)

FTAs have been negotiated, first by the United States, and more recently by Japan, the EU, and others, and include provisions on foreign investment similar to those in BITs.

* For a list of BITs with relevant information by country, see http://www.unctadxi.org/templates/docsearch____779.aspx

Box 7. Types of Private Investors

- Corporations and other business legal entities
- Individuals and unincorporated entities such as partnerships (business entities without independent legal personality)
- Not-for-profit organizations and foundations

private investment. Most investment codes only seek to regulate private investment, that is, investment realized by a person in the private sector, be it a juridical or natural person (Box 7).

Direct Investment v. Portfolio Investment

An important distinction that should be made is between direct and portfolio investment. This has practical implications on the content of investment legislation.

Direct investment is a long-term investment in a

Box 8. Types of Direct Investment

- Enterprise creation, such as establishment of a new business and construction of a facility. This is often referred to as “greenfield” investment.
- Investment in an existing enterprise generally to expand or reorganize a business. This includes acquisitions or mergers.

new business or a preexisting one that is accompanied by a measure of effective management control by the investor. The investor exercises a dominant influence on business operations, and remains responsible for the development of the enterprise. Direct investment is a lasting interest in an enterprise and is typically illustrated by ownership of physical assets such as buildings, machines, and other lasting interests that

are not easily liquidated (Box 8).

When an investor is an individual who owns physical assets in an enterprise, it is not difficult to identify this as a direct investment. But most investments today are made in corporations or limited liability companies that have an independent legal personality. In such cases, the test of a direct investment derives from the degree of control exercised by a shareholder and its influence over the management of the corporation.

Control is assumed when an investor owns the majority of the equity capital of a corporation, or has the majority of the voting rights on the board of directors.

Sometimes relatively lower thresholds are enough to confer “control” over the management of a corporation. It is often assumed that 10 percent of the equity capital or voting power of an enterprise gives the investor a significant degree of influence over the management of an enterprise.

However, sometimes an investor with a smaller share plays an active role, while a larger investor may remain passive. Hedge funds, private investment funds, and distressed funds are considered direct investors when they have equity ownership of 10 percent or more in an entity (Joice and Patterson 2006). Depending on the circumstances, a licensing agreement alone could provide a measure of control over an enterprise. Thus, the existence of control depends on the circumstances, which need to be assessed on a case-by-case basis.

In addition to financial resources, direct investment may result in a number of spillover benefits, such as product innovation, transfer of technology and know-how, management skills, increased market access, and employment generation.

Portfolio investment (also referred to as “indirect investment”) usually implies a shorter-term objective, the use of financial flows that have a higher degree of liquidity, and an investment that

Box 9. Types of Portfolio, or Indirect Investment

- Equity participation, including shares and stocks that do not provide any control or management of the company.
- Purchase of equity securities such as shares, stocks, participation, preferred shares, or the acquisition of debt instruments or securities such as loans, credits bonds, debentures, notes, or options.
- Contractual arrangements, such as licensing agreements or turnkey contracts that do not involve management control.

does not involve management control by the investor (Box 9).

Portfolio investments are generally more speculative than direct investments. Such investors can easily be persuaded to shift their investment from one security to another that is more profitable.

Because of their portability and short-term orientation, portfolio investments are usually not the focus of investment laws. Portfolio investments are regulated in a very different manner from direct investments, usually under the supervision of monetary and financial authorities such as central banks, ministries of finance or treasury departments and security and exchange commissions. Portfolio investment thus raises very different policy and

regulatory issues and many of the “lessons of experience” we share in this handbook will be of limited value and applicability to governments interested in promoting portfolio investment.

Foreign Investment v. Domestic Investment

An investor can be an individual, a public or private sector enterprise, a group of related individuals or of related incorporated or unincorporated enterprises, governments or government agencies, or estates, trusts, or other organizations (IMF 1993, OECD 1996).

A **domestic** investment is an investment made in a country by a resident or a national of that country.

In contrast, a **foreign** investment is an investment made by a person in a project or enterprise in a country other than their country of residence or nationality. Thus investments made by foreign nationals in the territory of a host state are considered as foreign investments.

The two key criteria for determining the foreign nature of an investment are nationality and residence. Depending on the criteria chosen by the country, an investment can be deemed domestic or foreign as follows:

Some differences can also be drawn depending on whether an investor is an individual or a corporation:

Box 10. FDI vs. Domestic Investment

Criterion	Investor			
	Resident/ National	Resident/ Non-national	Nonresident/ National	Nonresident/ Non-national
Nationality	Domestic	Foreigner	Domestic	Foreigner
Residency	Domestic	Domestic	Foreigner	Foreigner

- **In the case of individuals:**

Dual nationality, where an investor holds the nationality of both the host state and of another state, can lead to difficulties with classification. Some legal instruments, such as articles 25 of the ICSID Convention seem to retain the sole criterion of nationality for natural persons.

- **In the case of corporations:**

The most widely used criterion is the place of incorporation or the registered office (*siège social*); however, some host countries' legal systems apply the "control test" to determine whether the corporation is a foreign investor (ICSID Convention article 25).

In the systems where the control test applies, a corporation's nationality is impacted by the nationality of investors having the control; because of foreign control, the host state considers a corporation as a foreign national for purposes of certain specific legislations such as investment law even if such corporation is incorporated in the host state.¹ It does not matter in this respect whether the foreign investor has the majority or minority equity in the corporation; what matters is whether the said investor has the control.

Why is the distinction between foreign and domestic investment important?

The distinction between FDI and domestic investment is important for the scope of the legislation.

In recent years, a number of countries have adopted comprehensive or omnibus investment laws that cover both FDI and domestic investment. This phenomenon recognizes that domestic investment is do

important as, if not more important than foreign investment and that concerns about security of investment, dispute resolution mechanisms, and human capacity constraints are not limited to foreign investors.

Other countries have adopted laws on FDI only, while domestic investment is covered by all other national legislation.

There is no best practice in this area. There are valid arguments for each of these two options.

- **Arguments in favor of a law covering FDI only**

Domestic investors are more familiar with the domestic legal framework than foreign investors. If an important policy objective of the government is to attract more FDI, having a specialized law for that form of investment makes sense. Of course, the law should not lead to discrimination against domestic investment/ors.

- **Arguments in favor of a law covering both domestic and foreign investment**

Countries used to have two separate investment regimes, one for foreign and one for domestic investment. The past two decades have seen a major convergence of such regimes. Having a law that covers both domestic and foreign investment is becoming increasingly common. From a technical point of view, such a law may be somewhat more complicated to write, as rules that apply only to foreign investors (such as profit repatriation) will be intertwined with provisions for domestic investors only and provisions applying to both foreign and domestic investors, but it is technically feasible.

In the modern world of commerce, what used to be categorized as foreign investor concerns, such as the existence of rules for fair compensation in the event of expropriation,

¹ See ICSID Convention, Article 25(2)(a) and (b).

the opportunity to hire expatriate staff in the absence of local capacity, the need to settle commercial disputes fairly and expeditiously, and the ability to convert local currency into foreign exchange to service foreign debts, now are recognized to also concern domestic investors. This recognition, together with the reality that FDI laws have – unwittingly or intentionally – created a two-tier system that is perceived to prejudice domestic investors, provides little support or justification for legislation that exclusively addresses the specific needs of foreign investors. The needs of both domestic investors and foreign investors – to the extent that they are not the same – can certainly be reconciled in one law.

A major benefit of having a law covering both domestic and foreign investment is that it removes an important risk for government, which is being perceived as favoring foreign investors over domestic investors. In countries where this risk is elevated, the government should consider omnibus legislation covering both domestic and foreign investors.

In contrast, if this risk is low, and the government had a previous policy hostile to FDI, then the government might consider adopting a single, transparent piece of legislation covering all important FDI issues such as conditions of admission, guarantees offered, the institutional framework, and incentives enabling foreign investors to easily access the information and evaluate investment conditions in the country. Based on the above,

the decision of a country to proceed with one law covering both foreign and domestic investment or not should be based on the history and particularities of the said country and determined on a case by case basis.

Conclusion: Whether a country chooses a law covering both foreign and domestic investment or one covering only foreign investment, what really matters is that the investment law should not create different standards of treatment between domestic and foreign investors. Seeking to reassure foreign investors and assuage their specific concerns by providing clear legislative guarantees does not mean that the government is discriminating in their favor against domestic investors.

IC supports and advises reform programs that remove constraints and streamline procedures for all private sector firms, whether domestic or foreign. We strongly recommend against any provision that introduces any sort of discrimination between domestic and foreign investors. Removing key constraints in the investment climate that affect private enterprise productivity is a very large part of our advisory and technical assistance programs.²

² This assistance is provided by the various units of the WBG and International Finance Corporation (IFC), including the IFC's regional facilities (such as the IFC Investment Climate Advisory Services in Africa) and IC among others.

CHAPTER 2: PERVASIVENESS, USEFULNESS, AND LIMITATIONS OF INVESTMENT CODES

This chapter looks at the “universe” of investment codes.³ How widespread such codes are and why do some countries choose to have an investment code, and others not? What is the usefulness, actual or perceived of investment codes and what are their limitations?

Pervasiveness (“To Have or Have Not”)

Since 1992 the number of countries around the world having national investment codes has considerably increased and Box 11 shows the diversity of countries that had or have investment codes. The list dispels the often-heard myth that this instrument is used mainly by developing countries and countries with romano-germanic legal tradition.

³ The term “investment code” is a general term for a wide range of legislative instruments: foreign company act, foreign investment promotion act, foreign investment statute, legislation on foreign capital, and others. Because using all these terms here might be confusing, the handbook limits itself to “investment code” or “investment law/legislation.”

Box 11. International Distribution of Investment Codes

- Investment codes exist in all types of economies – large and small, industrialized and developing, socialist and market-oriented, and transitional.
- Contrary to common belief, investment codes are not a “developing country” phenomenon: Canada, New Zealand, and several EU countries have or until recently had investment codes.
- Investment codes are not reserved to a particular legal tradition: Common law countries with an investment code include Bangladesh, Ghana, Kenya, Malawi, Pakistan, Tanzania, and Uganda.
- Civil law (Napoleonic or “romano-germanic” tradition) countries with an investment code include countries as diverse as Brazil, the Democratic Republic of Congo, Kazakhstan, Senegal, and Turkey.

Countries without investment codes: Is investment unregulated?

France, Singapore, and the United States are interesting examples of countries that do not have an investment code and yet attract large levels of FDI. From the 1950s through the 1970s, Brazil was the leading FDI recipient among developing countries, without having an investment code.

Does it mean that these countries do not regulate foreign investment, that investment is totally free, or that investors have no guarantees?

The answer, of course, is no. In such countries, the guarantees, restrictions, and rules governing investment simply are found elsewhere in the legal framework: in the Constitution; in separate laws and regulations dealing with commercial activity, expropriation, taxation, and foreign exchange; or in laws governing specific sectors (such as banking, finance, insurance, telecommunications, mining, or tourism). It is therefore important to move away from the notion that “no investment code equates no rule governing investment, no guarantee, or total freedom.”

As stated above, some countries choose to centralize investment-related regulations in a special piece of legislation called an investment code, while others regulate these regulations through various national laws. The fact that the same guarantees or conditions can be as effectively introduced through other laws and regulations actually supports the notion that a key function of investment codes is investment promotion.

Is there any strong advantage of one approach over the other?

In choosing between the two approaches, the government’s principal consideration should be to ensure that the legal framework clearly recognizes and effectively protects the

Box 12. Advantages of Consolidating Investment Regulations into a Code

- For government, drafting and adopting one piece of legislation can:
 - Save time
 - Save scarce resources*
 - Be easier to amend than several laws and regulations (when circumstances necessitate revisions)
 - Be easier to implement
- For a prospective investor, finding most of the guarantees and rules applicable to its investment in a single text is much more convenient than having to review a number of disparate laws and regulations to understand how open the country is and to be immediately reassured about the security of investment and property.

*Although it is doubtful that a serious flaw or gap in the overall legal framework can be redressed simply by inserting a provision or two in the investment code. An expropriation clause in the code is no substitute for a good expropriation act.

fundamental rights under which investors expect to operate. The legislative vehicle that governments use to effectively introduce and enforce such principles and guarantees in the country is less important.

However, there is an obvious advantage in having one central piece of legislation that specifies which sectors are open to foreign investors, what the entry requirements are, what guarantees investors have, and which public institutions (such as IPIs or one-stop shops [OSS]) they can access for assistance. Box 12 lists additional advantages.

One host-country legislative instrument that foreign investors usually want to review themselves, rather than through a local lawyer, is the investment code (another one is a summary

of the tax system for businesses). So, if a country does not have an investment code, it could, at least in theory, miss the opportunity of receiving the interest from this potential foreign investor.

In addition, from a practical point of view, governments with low capacity and capabilities would do better to have a single investment code in which government officials can find most of what they need to know about investment regulation in their country.

Usefulness

Developing an investment code has been popular for some time and shows no sign of abating. One successful example is Turkey (see the case study in Appendix 2).

Clearly, the policymakers and nations that have adopted an investment code must see the benefit of such a tool.

Why do countries choose to have an investment code?

Investment codes serve two key purposes:

1. They help to implement government policy on private investment (domestic or foreign). They translate policy into legislative language, and embed it in a normative instrument that has the force of law. Administrative agencies can then apply the instrument, and parties can use it in a court of law or arbitration proceedings.
2. They also are an important tool for supporting investment generation.

As a policy implementation instrument, investment codes have been particularly useful in countries that have undergone a radical change in economic orientation, notably the former command economies of Central and Eastern

Europe. Although investment codes appeared in that region prior to 1989 (in Hungary and Poland), they became pervasive throughout the region after the collapse of the communist system. In effect, the new governments used investment codes to send a clear signal to investors that there had been a major change in policy toward private/foreign investment, and that they were now “fully open for business” and offering necessary guarantees starting with the recognition of private property rights (which most socialist economies did not recognize). The **signaling function** of investment codes is not to be underestimated and has been extensively used by many developing countries including in Africa, Asia, and Latin America, following important changes in economic policies.⁴

Investment codes are obviously also a legal tool that may augment **legal security** and **transparency**, by providing the fundamental guarantees that investors expect, by correcting gaps or inconsistencies in the legal framework, and by clearly stating the entry requirements and sectoral restrictions that exist in the country.

By informing potential investors of the conditions to invest in the country, as well as of the guarantees that they will receive, investment codes, if enforceable, can provide investors with the comfort they seek when investing in a foreign jurisdiction, particularly a developing economy. This is why we often take the view that the investment code is not “just” a legal tool but also a potentially important promotional tool that can support the government’s effort to attract more private investment, particularly FDI.

Box 13 summarizes the various purposes that investment codes serve.

As we have shown, investment codes can serve several purposes. However, they are not a

⁴ On the “signaling” function of investment codes in transition economies see Gray and Jarosz (1995).

Box 13. Purposes of Investment Codes

- 1.**

It is an instrument of policy implementation

An investment law:

 - is an instrument of policy implementation in terms of:
 - a. the role of the private sector in the economic development.
 - b. industrial policy (that is, which sectors to favor or not and for whom).
 - c. the role of FDI in economic development.
 - contributes to setting up or clarifying rights and obligations of investors, of the host government and its administrative agencies, and of other investment stakeholders.
 - is a vehicle to strengthen the rule of law in this field of paramount economic importance.
 - deals with institutions related to investments, and their operations and impact.
 - establishes a governmental framework for the protection and promotion of investment, which is an essential ingredient of economic development.
- 2.**

It is a tool for investment promotion and investment climate reform

Promotion starts with informing potential and existing investors, and the code certainly contributes to this. But an investment code can also help to improve the country's investment climate through a reduction of legal and institutional barriers to private investments. The establishment of a stable and consistent framework is in itself an incentive and a signal to investors, and a mean to expand domestic enterprise and access international investment markets.
- 3.**

It provides security to private investments

A peculiar feature of most investment operations, compared with trade transactions, is their duration. Because their timeframe is much longer, investors look for a stable and predictable legal framework and for institutions with authority over their investments. Investors value the legal security provided by investment legislation, and this influences their investment decisions.
- 4.**

It enhances transparency in investment operations contributing to good governance

Faced with the complexities and uncertainties of many national legal systems, investors look for a single piece of legislation that brings consistency and homogeneity to the legal framework covering their investments, instead of myriad legal provisions and administrative rulings. Transparency implies that all relevant legislative and regulatory provisions have been published and that they are made easily available in a comprehensive form to interested investors.

Source: IC research

panacea. In fact, it is very important to discuss their limitations.

Limitations

There are limits to what even the best investment code can achieve.

- **First limitation:** An investment code does not constitute the entire legal and regulatory framework applicable to economic activities. Investors, foreign or domestic, are subject to all the laws and regulations of the country of investment. If such laws are overly restrictive of private business, even a well-written investment code will not produce an environment conducive to investment.
- **Second limitation:** Investment legislation must be well implemented and enforced. While well-crafted legislation is essential to implementation and enforcement, the legislation is worthless if administrative practices undermine it or courts or arbitration do not enforce it. Technical assistance for investment code reform should extend to these additional steps.
- **Third limitation:** The overall legal framework (of which the investment code is a small part) is only one of many components that constitute a country's investment climate or attractiveness. These include the economic policy framework (trade, fiscal, foreign exchange, land and labor); the bureaucracy, with its ability to regulate and promote the business environment; the judiciary, with its ability to protect property, settle disputes, and enforce contracts; and the quality of both the physical infrastructure – power, transportation, and water –and institutional infrastructure – educational and banking systems and civil society institutions and business opportunities such as the size of the

market or highly advantageous production costs. To foster the development of a good investment climate, those factors need to be addressed in conjunction with the investment code to form a coherent system attractive to potential investors, domestic and foreign. Obviously, each investor will have a different view on the relative importance for their business of these different dimensions of the investment climate, but, generally speaking, they are all important factors and need to be addressed to establish an attractive business environment.

Box 14. Usefulness and Limits of Investment Codes

Investment codes are useful in the following ways:

- As the chief instrument to implement government policy on investment
- As a binding legal tool for security and predictability that investors can invoke in court or arbitration proceedings
- As a signal to investors after a country has undergone major political or economic policy changes that open up investment
- As a promotional tool providing critical information to prospective investors

Investment codes have limits. An investment code by itself will never create a first-rate investment climate that attracts investment. The country also needs:

- Complementary legislation on business and investment-related issues (company establishment and operation, protection of property, expropriation, dispute resolution, taxation, access to land, employment, trade, and so forth)
- Efficient and effective code implementation

A country's investment climate includes many factors and dimensions beyond the legal framework. Advisors in both the development community and private sector should communicate this to the government client and manage expectations.

Source: IC research



CHAPTER 3: PREPARING AN INVESTMENT CODE: OBJECTIVE, SCOPE, STRUCTURE, AND CHARACTERISTICS

Although a country must tailor its investment code to its own objectives, circumstances, and legal framework, being aware of what other countries, particularly those whose investment policy and code were instrumental in attracting significant private investment and FDI, have included in their code can be extremely valuable.

Objective and Scope

The key objective of the investment code is to promote private investment and protect the rights and property of investors.

Policymakers must define the scope of the investment code, that is, the types of investment the code should cover. (See Chapter 1 for explanations of each type.) Following is a summary of the key options.

- **Direct or portfolio investment:** As discussed in Chapter 1, portfolio investment differs substantially from direct investment.

As such, it is normally granted different rights and is subject to different restrictions and regulatory authorities. If the scope of legislation is limited to direct investment, the law will deal with the creation or acquisition of enterprises and the foreign investor exercising control or having a predominant influence over the management of the business. If the concept of “investment” is broader, the law will cover minority shareholdings, transfers of technology, and concession contracts. Our experience suggests the investment law should apply only to direct investment, and that concept needs to be defined at the outset of the law.

- **Private or public sector:** Interest in developing an investment code assumes that a country seeks private investment. But it must decide from whom or what it will accept investment: Individuals? Corporations? Noncorporate entities such as foundations, associations, or nongovernmental organizations? What about public entities such as sovereign wealth funds?

- **Foreign or domestic investment:** Policy-makers must decide whether the investment code should focus on foreign investment or cover both domestic and foreign investment.
- **New or existing investment:** It must be decided whether the legislation will apply to all investment – existing as well as new investment – or only to one category.
- **Form of investment to be governed:** This refers to the types of assets that can be invested (equipment, know-how, funds, and so forth). This will also affect the scope of the law and should be examined early in the process.

Structure and Characteristics

There is no international consensus on the recommended content for an investment code. However, some provisions in the World Bank guidelines are increasingly considered standard, almost universal.⁵ A review of recently adopted investment codes confirms this.

To fulfill its objectives of promoting investment and protecting investors, an investment code should have the structure and characteristics as discussed in Box 15.

⁵ See Shihata, (1993) and one of the papers that led to the guidelines: Parra (1991).

Box 15. Structure and Characteristics

Structure

1. Definitions:

A preamble or a “purpose and scope” section should appear at the beginning of the investment code, followed by a definitions section. The definitions set forth the key terms and concepts used in the law by reference to international standards. Here are the terms typically useful to investors:

- The law should specify the investments covered. It is preferable to retain a broad definition of the investment concept. Ordinary trade transactions and (short-term) monetary operations should be excluded. It should also be made clear that the legislation covers the investments made in conformity with the laws and regulations of the host country.
- One of the most important definitions is that of a “foreign investor.” The government will have to decide whether to base the definition on the investor’s nationality or residence. One factor to consider is whether the government wishes to seek investment from its own nationals residing abroad. Some countries have large numbers of nationals living as expatriates in other countries. Treating them as “foreign investors” under the investment law can be an incentive for them to invest some of their earnings in a productive way in their homeland.
- It is common for an investment law to distinguish between a “resident” and a “nonresident,” mainly to address the issue of whether the investor is entitled to repatriate profits and capital. Investment codes frequently use the definitions of these terms that are found in the country’s foreign exchange law.

Good practice: It is international good practice to define “nonresident” in a broad, all-encompassing way, not subject to any significant limitations.
- Another important definition is the distinction between direct investment and portfolio investment.
- The investment law should define investment-related institutions and authorities mentioned in the law, as well as the entities that will implement the law. This will help the investor understand the steps of the investment process.

Box 15. Structure and Characteristics (continued)

Structure

- 2. Entry:** An important issue for the preparation of the investment policy and then the investment code is how the country will regulate investors' entry and in particular foreign investors' entry. The trend today is toward an open-admission approach. Examples of entry barriers used in investment codes that do not have an open admission are the following:
- sectors restrictions through positive or negative lists. If the government insists on restricting investment in certain sectors, it is advisable to have such sectors listed in the investment code in a short, clear, and concise negative list.
 - Limitations on foreign ownership
 - Screening v. registration/notification
 - Minimum investment requirements
 - Performance requirements
- 3. Guarantees:** The "heart" of an investment law lies in a small number of guarantees and principles that are increasingly considered good practice and almost prerequisites for attracting serious investors. These fundamental guarantees (discussed in Chapter 5) include the following:
- Fair and equitable treatment
 - National treatment
 - MFN treatment
 - Guarantees against expropriation
 - Convertibility and repatriation of capital and "fruits of enterprise"
 - Settlement of disputes
 - Other provisions
- 4. Promotional devices:** An investment law may address investment promotion and incentives. Often, a government uses the investment code to:
- Establish the institutional framework in charge of promoting investment (either as a separate entity or as a unit within the ministry in charge of investment or private sector development).
 - Define investment incentives offered to investors and how they are granted.
- Although investment codes of many countries include provisions on these two issues, it is advisable to organize both incentives and promotion through other pieces of legislation. We will review those two issues in Chapters 6 and 7, respectively.
- 5. Transition:** An explicit transitional section at the end is useful for understanding how the law complements, amends, or repeals previous laws and regulations, thus reducing uncertainty and risks of "conflict" with other laws.
- Grandfathering clauses are usually included in transitional sections and create a framework by which existing investments are permanently or temporarily excluded from the ambit of new investment laws. Sometimes, albeit rarely, an option may be given to investors to choose to keep their investment package or to switch to the new one as provided under the new law.

Box 15. Structure and Characteristics (continued)

Characteristics

- 1. Length:** If a government's principal objective in preparing an investment code is to create a tool that will help in its investment promotion effort, a principle for the drafting team to follow is "less is more." There is some tendency to include in the investment law various provisions including tax, environmental protection, and establishment of corporations, which should be covered by the relevant pieces of legislation and not by investment codes. It is important, however, for an investment code to refer to such other legislation when necessary. The law should be as short and clear as possible. There is no ideal length for an investment code, but common sense should prevail. For instance, investors with significant presence in Eastern Europe who may have looked at the Belarus investment code of 2001 were probably not reassured by the fact that it contained 105 clauses. Prospective investors are likely to assume that a lengthy code is indicative of a cumbersome, restrictive, and probably unpredictable policy and regulatory environment. In contrast, the foreign investment statute of Chile (decree law # 600) had 18 articles. A short code, if it includes basic guarantees and entry rights, is more likely to be an effective promotion tool than a lengthy one.
- 2. Accessibility:** Investment legislation should be easily accessible to foreign investors and published in an easily comprehensive format. It should be published without undue delay. To the extent possible, the host government should publish in advance any measure that it proposes to adopt, and provide investors an opportunity to be kept informed on such proposed measures.
- 3. Transparency:** The investment code should be transparent, allowing investors to know not only the basic rules but also the procedures investors should follow. Transparency requires ready access to reliable, comprehensive, timely, and understandable information.*

* http://www.transparency.org/news_room/faq/corruption_faq#faqcorr2 and http://www.estandardsforum.org/about_standards/code-of-good-practices-on-transparency-in-fiscal-policy

Preparing an Investment Code in Subnational and Conflict-affected Areas

Investment Codes in a Subnational Context

When considering subnational investment law reform, it is important to start by reviewing the devolution of powers to the subnational government, to (i) check whether the devolution is clear and (ii) determine to what extent the subnational government has authority and

autonomy. This is important to determine whether the new or reformed subnational investment law will be implementable. Even where the subnational government is semi-autonomous (has direct authority within its borders subject to existing national laws, regulations, and procedures), it may encounter problems if it tries to make significant changes such as streamlining and simplifying the regulatory regime:

- It might be deemed contravening national law.

- Other parts of the country may refuse to recognize the investment licenses and permits it issues, meaning its investors risk increased difficulties in doing business in the rest of country.

Investment Codes in Conflict-affected Areas

In post-conflict areas, investment law reforms have a good chance of being adopted because often the government will be willing to adopt liberal investment policies and donors are more likely to assist with reform. However, a post-conflict government might have to make tradeoffs when developing its investment law reform:

- The government's need to attract investment in the short term may conflict with a law written for the longer term, once the economy is healthy.
- The country's need for immediate, expensive infrastructure (re)construction might limit the government's bargaining power with investors.

Investors entering into investment agreements in a post-conflict country might try to take advantage of the situation. Such agreements likely will need to be revised and renegotiated, with better terms for the government, or even cancelled. For example, Liberia's 2005 iron ore concession to Mitta Steel had to be renegotiated in 2007 with better terms for Liberia. In addition, when the investment agreement is confirmed by a legislative act, a similar act may be required to amend the agreement (i.e. a

legislative act) and such ratified investment agreement may in certain jurisdictions supersede national provisions such as labor, environmental etc.

Consultations on the design and enactment of new or revised investment laws can take longer and be more complicated in post-conflict settings. The law must anticipate post-war political sensitivities without restricting the principles of commercial practice. For example, the law might have to restrict investments in certain subnational locations. It might also have to (i) contain different provisions, some that would apply before the peace process is completed and some afterwards, or (ii) be amended after the peace process. Where multiple political parties have conflicting interests, the law might have to provide for an investment committee that would comprise members of each party and require investment decisions to be made by consensus instead of by majority.

The following chapters discuss the various issues that may discourage or encourage investors to invest in a country. Although the recommendations below will most immediately benefit individual investors, more importantly, the resulting investments are likely to benefit countries over the long term through increased employment, transfer of technology, revenue generation, among others. Eliminating unnecessary approvals is not only good for investors but also for the government – streamlining the approval process can lower costs, avoid opportunity costs, diminish the risk of losing projects, reduce opportunities for corruption, and improve the image of the country both domestically and externally.



CHAPTER 4: CONSIDERATIONS FOR ENTRY OF FOREIGN INVESTMENT

An important issue for the formulation of the investment policy and investment code is how the country will regulate “investor entry” (or “admission”) and in particular “foreign investor entry.” Entry is a special requirement imposed on investment projects. It is usually not an issue for domestic investors, who, by definition, are resident in the country and can invest under the normal procedure generally defined in the law. We have elected therefore, to dedicate this chapter to entry of foreign investors. However, it is important to note that in many countries, entry can also apply to domestic investors such as when certain strategic sectors (such as infrastructure) are restricted or subject to special conditions.

Some countries, especially developing countries, have a screening process that subjects foreign investment projects to host-country review and formal authorization before project implementation can begin.

Since the early 1990s however, the trend in admission of foreign investments is toward a more open or liberal policy. Today, the open-admission approach prevails in countries of the Organization for Economic Co-operation and Development (OECD) and in an increasing number of developing and transition countries as well.

In an open-admission system, the host country admits foreign investment without a formal screening and approval process. In some cases, a filing or notification requirement is required from the foreign investor purely for statistical or investor after-care purposes.

Even with an open-admission system, a country may impose restrictions on foreign investment, usually for host-country national security concerns or economic development objectives. The World Bank guidelines on foreign investment (WBG 1992) recognized this possibility (Guideline II, Section 4):

“Without prejudice to the general approach of free admission recommended in Section 3 above, a State may, as an exception, refuse admission to a proposed investment:

- which is, in the considered opinion of the State, inconsistent with clearly defined requirements of national security; or
- which belongs to sectors reserved by the law of the State to its nationals on account of the State’s economic development objectives or the strict exigencies of its national interest.”

The restrictions to foreign investment can be general or sector based, and they usually take the following forms that will be detailed below:

- Certain sectors are closed to foreign investment
- Foreign ownership is allowed but can be limited to a certain percentage of overall ownership, either in general or in certain sectors.
- Foreign investment is allowed but is subject to prior authorization based on “strategic sector” rationale
- Foreign investment is subject to general screening and approval (for other reasons than on “strategic sector” rationale)
- Foreign investment is subject to a minimum investment requirement
- Foreign investment is subject to certain performance requirements.

There can be overlap between these forms of restrictions.

Sectors Closed to FDI

Few countries are completely open, allowing foreign investment in all sectors and subsectors, and under identical conditions and procedural requirements as domestic investment. Chile, Guatemala, Georgia, and Montenegro allow foreign ownership of all major sectors in their economy.⁶

One country that is nearly open is Mauritius, which limits FDI (and all private investment) in nationalized sectors such as electricity transmission and distribution, waste management and recycling, and port and airport operation are characterized by monopolistic market structures, with one dominating publicly owned enterprise, making it difficult for foreign companies to invest.⁷ In the past 15 years, the trend in many developing countries has been to allow foreign investment in even previously government-owned and -operated sectors. In spite of the trend toward openness, many countries still restrict or prohibit foreign investment in various sectors including the media, defense, and nuclear industries.

The OECD FDI Regulatory Restrictiveness Index of 2008 (OECD 2008) found that:

- Among OECD countries, the EU countries are generally more open than others
- Among non-OECD countries, those of Eastern Europe, Chile, and Argentina are among the most open whereas India, China, and Russia are the most restrictive
- The most restricted sectors are electricity, transport, telecommunications, and finance
- The least restricted sectors are manufacturing, tourism, construction, and distribution.

⁶ World Bank Group Investing Across Borders database

⁷ World Bank Group Investing Across Borders database

Box 16 gives examples of sectors closed to foreign investment, by country.

Governments generally use either a “positive list” or “negative list” approach to implement sectoral restrictions.

- In a **positive list** approach, the government attempts to enumerate all the sectors or subsectors in which foreign investors may invest. Only a minority of countries use this approach. The list cannot possibly cover the whole economy, and keep up with the development of new industries. Also, the treatment of the sectors or subsectors that are not on the list is ambiguous. As such, the positive list approach is not recommended.
- A much more common approach is the **negative list**, under which authorities list the sectors or subsectors that are closed (prohibited) or restricted (allowing only minority foreign ownership, requiring special authorization from foreign investors, and so forth). This system is preferable to the positive list for a simple reason: if a sector or subsector is not on the list, investment in that sector is automatically deemed allowable without restriction. Of course, a long negative list means that the country is not really open to FDI and defeats the benefit of the negative list. The negative list should be as short as possible and should be revised over time as restrictions are lifted. It should be a dynamic process, not a static one. The negative list should be precise (not open to

Box 16. Examples of Sectors Closed to Foreign Investment

The following list shows a range of examples of sectoral restrictions on foreign investment in selected countries.

- **Brazil:** The health care sector is completely closed to FDI.
- **Canada:** The health care sector is de facto closed to FDI because private hospitals and clinics may not receive payments from provincial health insurance funds, which are critical for the financial viability of operators in the sector.
- **China:** Sectors such as publishing, television broadcasting, and newspaper publishing are closed to foreign investment.
- **Egypt, Arab Rep. of:** Publishing a daily newspaper is limited to domestic companies.
- **Greece:** The Hellenic Transmission System Operator S.A. is granted exclusive rights to the transmission and distribution of electricity in Greece. Private capital participation, domestic or foreign, in those sectors is, therefore, not possible. The electricity generation sector is also completely closed to FDI from countries outside of the EU. Presidential Decree 41/2005 imposes the same restriction on the railway freight transportation sector.
- **India:** Sectors such as railway freight transportation and forestry are dominated by public monopolies and are completely closed to foreign investment. With the exception of certain activities specified by law, foreign investment in the agriculture sector is also not allowed.
- **Mexico:** In the service industries, foreign investors are not allowed to engage in electricity transmission and distribution. Foreign ownership in electricity generation companies is possible under certain circumstances. The oil and gas industry is also completely closed to FDI as well as the ownership of nationwide television channels.
- **South Africa:** Monopolistic market structures with dominating publicly owned enterprises that inhibit FDI include the electricity sector as well as in the port operation and railway freight transportation sectors.

Source: World Bank Group Investing Across Borders database

interpretation and should be in any event strictly interpreted), and limited in scope and sectors. An example of an unclear and broad restriction that some negative lists include and that is sure to create interpretation problems is this: Any sector that has a negative impact on environment.

Box 17 provides illustrative examples of negative lists. It should be noted that IC does not recommend that a country adopt such lists but provides them simply as examples of negative lists in existing legislation. Appendix 3, on Liberia's FDI Entry Exclusions, discusses this issue further.

Sectors Subject to Limits on Foreign Ownership

Investment codes may also limit the percentage of equity that a foreign investor can own. (See Box 18 for examples.) This restriction in effect forces foreign investors into joint ventures with local investors, and in some cases, with the host government.

The limitation on foreign ownership can be general or limited to certain sectors. Among its disadvantages is that it increases the cost of private capital. For instance, where there are ownership limitations, foreign investors may transfer a less-advanced technology to protect a more advanced one. A local partner's lack of financial or managerial resources may also limit growth of the project (Salacuse 2000).

Box 17. Negative Lists: Some Examples

Many countries close or restrict certain activities or sectors to foreign investment, usually for national defense. Typical examples are the military sector and the media. Other limitations are based on the country's economic interests. The range of restrictions is wide, as seen in the following examples.

Kosovo's Investment Regulation (UNMIK) # 2001/3 stated:

Section 5: "With the exception of the specific industries listed in section 6, foreign investors may wholly-own and wholly-control business organizations in all sectors of the economy of Kosovo. Foreign investments in strategic or other specific sectors shall be subject to the same licensing requirements by the authorities as domestic business organizations."

Section 6: "Foreign investors may have not more than a forty-nine per cent (49 percent) ownership or control interest in business organizations that are manufacturers or distributors of military products."

Republic of Angola's Foreign Investment Law # 15/94 stated:

Article 3. (Permissibility of Foreign Investment)

2. Foreign investment is prohibited in the following areas:

- a) defence, internal public order and State security;
- b) banking activities involving central bank and issuing bank function;
- c) other areas which are considered by law to be absolutely reserved for the State.

Source: IC research

Authorization Requirement for "Strategic Sectors"

Many countries subject foreign investments in certain "strategic" activities to authorization for reasons of national security or economic interest.

Box 18. Examples of Limits Imposed on Foreign Ownership

- **Argentina:** According to the Aeronautic Code (Law No. 17,285) foreign capital participation in companies providing commercial air transportation of passengers, on both domestic and international routes, is limited to 49 percent. In addition, the company must be incorporated according to Argentine laws and must be domiciled in Buenos Aires. For the media sectors, Law No. 25,750 establishes a limit on foreign ownership of newspapers, journals, magazines, and publishing companies, as well as on television and radio companies. According to article 2 of the law, foreign companies are allowed to hold up to a 30 percent stake in the capital and voting rights of such companies.
- **Brazil:** Restricts foreign equity ownership in the air transportation sector to a maximum of 20 percent and in media industries (both TV broadcasting and newspaper publishing) to 30 percent.
- **Canada:** Foreign capital participation in the domestic and international air transportation sectors is limited to a maximum share of 49 percent. Furthermore, under the Canadian telecommunications and broadcasting regime, foreign investors may own only up to 20 percent of the shares of a Canadian operating company directly, plus an additional 33 $\frac{1}{3}$ percent of the shares of a holding company. On aggregate, total direct and indirect foreign ownership in the telecommunications sector (fixed-line and mobile/wireless infrastructure and services) and in the television broadcasting sectors is limited to 46 $\frac{2}{3}$ percent.
- **China:** In several sectors, including telecommunications (fixed-line and mobile/wireless), electricity transmission and distribution, railway freight transportation, air transportation (domestic and international), and airport and port operation, foreign ownership is limited to a less-than-50 percent stake. Further restrictions are imposed on foreign capital participation in the oil and gas industry, the financial services sectors (banking and insurance), health care, and the tourism industry.
- **Egypt, Arab Rep. of:** Foreign ownership is limited to a minority stake in sectors such as construction and air transportation.
- **Greece:** Greece imposes restrictions on the air transportation sector, in which foreign investment is limited to 49 percent. This equity restriction, however, only applies to investors from countries outside of the European Economic Areas. Furthermore, foreign capital participation in the airport operation sector is limited to a less-than-50 percent share.
- **India:** Foreign ownership of publishing companies and newspapers is limited to 26 percent. In the financial services sector, foreign investment in local banks is limited to 87 percent and in insurance companies to 26 percent. Furthermore, FDI in the telecommunications sector (including fixed-line and wireless/mobile infrastructure and services) is limited to a less-than-75 percent stake.
- **Mexico:** Foreign capital participation in the agriculture and forestry sectors is limited to a maximum share of 49 percent and in fixed-line telecommunications, railway freight transportation, port and airport operation, and newspaper publishing to a less-than-50 percent stake.
- **Poland:** The media sector is subject to foreign ownership restrictions in Poland, too. Pursuant to the Broadcasting Law, the required license to operate a TV broadcasting company may only be granted if the voting share of foreign owners does not exceed 49 percent and the majority of the members of the management and supervisory boards are of Polish nationality with permanent residence in Poland. Polish laws impose a maximum share of 49 percent for foreign capital in air transportation companies. In addition, foreign capital participation is limited to 49 percent in the airport and port operation sectors. The perceived difficulty of obtaining required operating licenses further inhibits FDI in the port operations sector, which is currently dominated by publicly owned operators.

Box 18. Examples of Limits Imposed on Foreign Ownership (continued)

- **United States:** According to the Federal Aviation Act of 1958, foreign investors can hold a maximum of 25 percent of the shares of a company providing domestic air transportation services in the United States. Furthermore, the president and at least two-thirds of the board of directors and other managing officers of such a company must be U.S. citizens. The aforementioned restrictions do not apply to the provision of international air transportation services, which are fully open to FDI. The Communications Act of 1934 specifies that foreign investment in the TV broadcasting sector is limited to 25 percent. However, the Federal Communications Commission (FCC) has the discretion to allow higher levels of indirect foreign ownership (up to 100 percent) if consistent with the public interest. Cable television providers are exempted from this restriction.
- **South Africa:** Foreign investment in the mining as well as in the oil and gas industry is limited to a maximum of 74 percent by the Mineral and Petroleum Resources Development Act 28 of 2002. Furthermore, the share of foreign capital in companies owning or operating telecommunications infrastructure or providing telecommunications services cannot exceed 30 percent in order to obtain the required operating licenses. In the media industry, foreign ownership of nationwide TV channels is limited to 20 percent.

Source: World Bank Group Investing Across Borders database

For instance, Article L 151-3 of France's Monetary and Financial Code as modified by law n°2004-1343 of December 9, 2004, submits for the Minister of Finance's prior approval certain foreign investments in activities pertaining to public authorities:

- Activities that could damage public security or national defense interests
- Activities concerning research, production, or marketing of weapons and explosive substances⁸

In other countries, the government can prevent a specific foreign investment in sectors that are generally open. For instance, no U.S. law forbids a foreign takeover of the major defense-contracting firms. However, the 1988 Exon-Florio Amendment⁹ authorizes the President, after investigations, to restrict, suspend, or prohibit mergers, acquisitions, or takeovers of

U.S. persons by foreign interests when such acquisitions threaten national security. The Committee on Foreign Investment in the United States (CFIUS) has 30 days to decide whether to investigate a case and an additional 45 days to make its recommendation and the President has 15 days to make a decision after receiving CFIUS' recommendation. Congress may also decide to block any FDI if national security is threatened. Box 19 provides illustrations of the Exon-Florio legislation in practice.

Screening Requirement for Non-"Strategic Sectors"

"The most problematic barrier to foreign investment is the presence of a screening mechanism" (OECD 1998, 37) to nonstrategic sectors.¹⁰

⁸ <http://www.legifrance.gouv.fr>

⁹ Section 721 of the Defense Production Act of 1950, 50 U.S.C. App. 2170 (as amended by the Foreign Investment and National Security Act of 2007)

¹⁰ For an analysis of this mechanism, see Shihata, (1994, 47-70).

Box 19. FDI in the United States: The Exon-Florio Amendment

The following are three illustrations of restrictions to FDI levied by the U.S. Congress based on the Exon-Florio amendment:

- **China National Aero-Technology:** In 1990, the state-owned China National Aero-Technology (CATIC), wanted to purchase the American Mamco Manufacturing Company, an aerospace parts manufacturer. After the Exon-Florio complete investigation, President Reagan forbade this acquisition. The rationale for this position was that CATIC might have gained access to technology through Mamco, while it would otherwise have needed an export license to obtain this technology.
- **Thomson-CSF:** In 1992, the French firm Thomson-CSF offered to acquire the missiles division of LTV Aerospace and Defense Company, which was in bankruptcy. Congress expressed concerns over a major defense contractor coming under foreign control. Indeed, this contractor produced important weapons and held large amounts of classified information. In addition, the French company was state owned and a major military contractor in France. An Exon-Florio investigation started, but Thomson-CSF withdrew the bid before a recommendation to block the transaction was made.
- **Dubai Port World:** In 2006, the state-owned company Dubai Port World (DPW), based in the United Arab Emirates, took over the British Peninsula and Oriental Steam Navigation Company (P&O), which operated six major U.S. ports. CFIUS approved the transaction without launching the Exon-Florio 45-day investigation after the 30-day review. Many congressmen expressed concern over the threat of this takeover on port security. However, President Bush argued for the approval of the deal and threatened to veto any legislation preventing the deal. DPW offered to defer the takeover of significant operations at the seaports to give President Bush more time to convince Congress that no threat existed. Yet, after a report showed that the deal covered not six but 22 U.S. ports, Congress blocked the deal with a veto-proof majority. In the end, DPW sold P&O's American operations to an American company.

Twenty percent of the countries around the world still require for example approvals for manufacturing for foreign investments.¹¹

A number of countries screen foreign investment projects. The rationale for screening is that governments need to decide whether a specific foreign investment is desirable. In general, the screening process involves an assessment of the investment's potential economic benefits for the host country. (See also Box 20.)

The argument against screening should be made at the economic policy and strategy level. The government's role should not be to decide which project is profitable or not. That is the role of the private sector. The government's role is to provide a "conducive" environment to allow beneficial

investment to be made and grow successfully.

Notwithstanding its objectives, screening is not an effective way to assess the benefits and costs of prospective investments because it is difficult to establish objective economic criteria for deciding whether a particular investment is desirable.

In addition, screening provisions tend to be so vague that they are often useless. Because of their lack of objectivity, screening provisions restrict FDI and reduce FDI inflows. Screening also costs agencies staff time and can lead to corruption, where the process permits discretion. (Rosenn 1998, 5)

From the investor's perspective, screening adds to their investment costs in the form of time delays, onerous compliance requirements, and what are generally described as "hassle costs." When an

¹¹ World Bank Group Investing Across Borders database.

Box 20. Various Modalities of Entry

- Simple registration of an investment project with the investment agency as part of an information and intelligence system to monitor the type and number of investors/investments made. (no screening)
- Minimal examination to ensure that the proposed project is not outside relevant legislation and/or policy requirements.
- Simple due diligence checks to verify a foreign investor's commercial standing and establish that the proposed investment is "serious," intended to reduce the risk of fraudulent activity by the investor. The additional issue would be in this regard the exact interpretation and definition of "serious."
- Detailed financial evaluations of the proposed investments' viability (based on feasibility studies or business plans) and assessment of their likelihood of success to avoid potential investment "failure."
- Complex cost-benefit evaluations that seek to examine the net impact of the proposed investment on the country. This may include an evaluation of economic and social impacts.
- Screening by host-country authorities to receive an approval. Those authorities often have to assess the economic impact of the proposed investment to decide whether they will approve or not.

investment agency is also a screener/decision-maker, the hassle cost can include the costs of rent-seeking behavior by corrupt agency officials. This is exemplified by a famous case in a Middle East country where approval of a joint venture between General Motors and Isuzu took seven years.

Foreign investors obviously prefer open, transparent, and unrestricted entry policies and practices, and tend to invest in countries that have minimal or no screening barriers to entry. Aware of this and of the issues entailed in

screening, many countries have reduced or eliminated screening requirements.

The screening process has been criticized for establishing cumbersome or complicated procedural regulations and for leading, in most cases, to inefficient results. An interesting example is provided by Canada, where the legislation in force remains based on a screening system, but the screening is no longer applied, except in exceptional circumstances (See Box 21).

For a more comprehensive treatment of the important question of registration procedures, see other IFC handbooks, in particular:

- Reforming Business Registration, February 2006
- Reforming Regulatory Procedures for Import and Export, June 2006
- Good Practices for Business Inspection: Guidelines for Reformers, October 2006
- Business Licensing Reform, November 2006

Minimum Investment Requirement

Some investment codes require a minimum amount of investment from foreign investors. This is to protect small domestic enterprises, traditionally the backbone of employment opportunities and economic growth.

This requirement should not to be confused with the minimum capital requirement stipulated by a country's company act for incorporation in the country. In certain countries, investment codes require a higher minimum capital than the company act, which can constitute an additional barrier to entry.

Box 21. Investment Canada Act of 1985

Under the Investment Canada Act, the following acquisitions of Canadian businesses by “non-Canadians” are subject to review by the Director of Investments:

- (a) all direct acquisitions of Canadian businesses with assets of C\$5 million or more;
 - (b) all indirect acquisitions of Canadian businesses with assets of C\$50 million or more;
 - (c) indirect acquisitions of Canadian businesses with assets between C\$5 million and C\$50 million that represent more than 50 percent of the value of the assets of all the entities the control of which is being acquired, directly or indirectly, in the transaction in question.
2. A “non-Canadian” is an individual, Government or agency thereof or an entity that is not “Canadian.” “Canadian” means a Canadian citizen or permanent resident, Government in Canada or agency thereof or Canadian-controlled entity as provided for in the Investment Canada Act. (...)
4. An investment subject to review under the Investment Canada Act may not be implemented unless the Minister responsible for the Investment Canada Act advises the applicant that the investment is likely to be of net benefit to Canada. Such a determination is made in accordance with six factors described in the Act, summarized as follows:
- (a) the effect of the investment on the level and nature of economic activity in Canada, including the effect on employment, on the utilization of parts, components and services produced in Canada, and on exports from Canada;
 - (b) the degree and significance of participation by Canadians in the investment;
 - (c) the effect of the investment on productivity, industrial efficiency, technological development and product innovation in Canada;
 - (d) the effect of the investment on competition within any industry or industries in Canada;
 - (e) the compatibility of the investment with national industrial, economic and cultural policies, taking into consideration industrial, economic and cultural policy objectives enunciated by the Government or legislature of any province likely to be significantly affected by the investment; and
 - (f) the contribution of the investment to Canada’s ability to compete in world markets.
5. In making a net benefit determination, the Minister, through the Director of Investments, may review plans under which the applicant demonstrates the net benefit to Canada of the proposed acquisition. An applicant may also submit undertakings to the Minister in connection with any proposed acquisition which is the subject of review. In the event of noncompliance with an undertaking by the applicant, the Minister may seek a court order directing compliance or any other remedy authorized under the Act.

However, the Director of Investments will not review a foreign investment project if the value of the gross assets of the Canadian business is less than an applicable threshold, which has been set over C\$265 million. In practice, it means that the legislation’s requirements will not be applicable to many foreign investment projects.

Source: An Act Respecting Investment in Canada, R.S., 1985, c.28 (1st Supp.) s.2

The minimum investment requirement either precludes smaller investments outright or precludes them from falling under the scope of the regime for “foreign investment” – and from benefiting from the legal guarantees and/or financial incentives provided by the regime.

Increasingly, countries do not set a minimum investment threshold. Arguments against a minimum are that any investment can become successful and grow into a larger business. This type of requirement may deprive the country’s economy of a number of smaller investments, which together could have a more important impact than a single large investment. Finally, in most thriving economies, SMEs are the backbone of employment opportunities and economic growth.

Recommendation on minimum investment requirement

Investment codes should not include any minimum investment requirement. Instead, they should encourage investments of any size, given that such investments have economic and social value. The potential impact of a business on the economy is not necessarily determined by its initial level of capitalization. For example, software development project might not require a large investment but can help a country in many ways. It is not clear that an investment of, say, US\$5 million (an amount we have seen in some investment codes) is superior or more beneficial to the host country than five projects of US\$1million each. At most, the only capital requirement should be the one already mandated under the country’s company act, based on the form of corporate entity to be created. Such a requirement should apply indiscriminately to both domestic and foreign investors.

Performance Requirements

Performance requirements are stipulations imposed on investors, requiring them to meet certain specified goals with respect to their operations in the host country (UNCTAD 2004 a,2). They can be imposed as conditions for FDI admission but also as conditions for the provision of some kind of advantages. However, the WTO does not welcome them, because they tend to restrict trade-related investment.

There are three categories of performance requirements. The first includes all the requirements prohibited by the WTO TRIMs Agreement because of their incompatibility with the General Agreement on Trade and Tariffs (GATT). The second contains requirements prohibited, conditioned, or discouraged by interregional, regional, or bilateral agreements. The third category of performance requirements consists of those that are not subject to control by any international investment agreement (IIA). (See Box 22 on Categories of Performance Requirements.)

Conclusion on performance requirements:

- The inclusion of specific obligations or requirements in investment legislation (beyond the normal obligation of complying with the laws of the land) has to be weighed carefully. Each requirement will be seen by potential investors as a constraint, limiting their freedom of choice, and, taken together, can dissuade investors from even considering the country as a possible investment location. So, from an “investment promotion” perspective, the inclusion of performance requirements, especially stringent ones that are not required in competing locations, and the ones that are unreasonable or poorly designed, can undermine the government’s strategy to attract investors.

Box 22. Categories of Performance Requirements

Category	Performance Requirement
Prohibited by the TRIMs Agreement	<ul style="list-style-type: none"> ■ Local content requirements (supposedly to promote local enterprise) ■ Trade-balancing requirements ■ Foreign exchange restrictions related to the foreign-exchange inflows attributable to an enterprise ■ Export controls (requirement to export a minimum percentage of the production)
Prohibited, conditioned or discouraged by IIAs at bilateral or regional levels	<ul style="list-style-type: none"> ■ Requirements to establish a joint venture with domestic participation ■ Requirements for a minimum level of domestic equity participation ■ Requirements to locate headquarters for a specific region ■ Employment requirements ■ Export requirements ■ Restrictions on sales of goods or services in the territory where they are produced or provided ■ Requirements to supply goods produced or services provided to a specific region exclusively from a given territory ■ Requirements to act as the sole supplier of goods produced or services provided ■ Requirements to transfer technology, production processes, or other proprietary knowledge ■ Research and development (R&D) requirements
Not restricted	All other performance requirements

Source: UNCTAD (2004 a,3)

- There is no evidence that the results sought can be achieved. For example, until 1999 Chile had performance requirements in the automotive industry. There is no evidence that those requirements helped raise local value addition in this industry. Neither has production been negatively affected by the elimination of the requirements. They can even have some unintended, negative consequences. For instance, it could be expensive for an investor to meet the requirements. Then, the cost of production might increase, raising the price of the products sold in the host country.
- Some performance requirements are not only counterproductive but can also be illegal under the international commitments of the host country. For instance, the WTO TRIMs Agreement has made illegal requirements for minimum local content, trade-balancing, export controls, or foreign exchange restrictions related to the foreign-exchange inflows attributable to an enterprise. (See Box 22 above.)

Summary of the Recommendations on Admission Policy and Procedures:

- The worldwide trend is toward more open admission systems allowing private

investment including FDI, in most sectors of the economy. However, if there is a desire to limit sectors where foreign or even domestic investors may invest the investment code should be transparent by defining clearly closed or restricted areas in a “negative.” A negative list should ideally be as short, clear, and nondiscretionary as possible.

- Admission policies should have as few sector-specific restrictions as possible (consistent with the government’s strategy to attract more investments) and a country should try to lift these restrictions as its economy modernizes and liberalizes. Some restrictions may be inevitable, for example, for national security, but they should be the exception, not the rule.
- The body of the investment legislation should only refer to the existence of a negative list and attach the actual list in a separate document such as a governmental decree. An executive-level norm is easier to amend than a legislative act. Experience shows that sector-specific restrictions will be lifted over time as the country continues to liberalize, and open its economy.
- We discourage screening of foreign investment just because it is a foreign

investment. That said, we also realize that some form of screening is used in many countries, particularly but not only in developing countries. When the government insists on having a screening, our recommendations are the following:

- When there is a special entry procedure for FDI, the law should clearly define the agency responsible for approval.
- The criteria for decisions and procedures should also be clearly defined and transparent.
- The responsible agency should decide the matter within a reasonable time period. The best laws utilize the “silence is consent” rule, which defines a time limit for decision; if a decision is not rendered within that time, the decision is deemed positive.
- If the foreign investor’s application is rejected, the authority should explain its decision.
- The investment code or its regulations should permit and organize an appeal mechanism to a higher government body or ombudsman.



CHAPTER 5: INVESTOR RIGHTS, GUARANTEES, AND OBLIGATIONS

If a country wants to attract significant levels of private investment and promote itself as a good place to do business, it must protect investments and investors in terms of the acquisition, management, conduct, operation, and sale or other disposition of the investments in the host country.

This chapter reviews the fundamental guarantees that investors seek and that, over time, have become synonymous with a good, open, modern investment policy, and thus investment legislation.

It should be noted from the outset that all the obligations below are usually also included in a BIT or other international agreement and any violation could lead to the activation of the dispute settlement mechanism in such agreements.

Fair and Equitable Treatment

Under national investment legislation, fair and equitable treatment (FET) should be accorded to all investors, although in practice, it is perhaps most important for foreign investors. The FET standard protects investors against discrimination and, where discrimination is claimed, provides due process of law. Countries in which national law provides insufficient or no protection to foreign investments should include the principle of FET in their investment code.

“The obligation to provide “fair and equitable treatment” is often stated, together with other standards, as part of the protection due to foreign direct investment by host countries. It is an “absolute”, “noncontingent” standard of treatment, i.e. a standard that states the treatment to be accorded in terms whose exact meaning has to be determined, by reference to specific

circumstances of application, as opposed to the “relative” standards embodied in “national treatment” and MFN principles which define the required treatment by reference to the treatment accorded to other investment.¹² The obligation of the parties to investment agreements to provide to each other’s investments FET¹³ has been given various interpretations by governmental officials, arbitrators, and scholars. Discussion of this standard has focused mainly on whether the standard of treatment required is measured against the customary international law minimum standard, a broader international law standard including other sources such as investment protection obligations generally found in treaties and general principles, or whether the standard is an autonomous self-contained concept in treaties which do not explicitly link it to international law. The implications of this discussion could be very broad, in particular given the growing number of arbitral awards which examine claims of denial of fair and equitable treatment.¹⁴ It is still debated in international law whether FET standard incorporates the minimum standard of treatment under customary international law,¹⁵ in particular as demonstrated in acts such as denial of justice (judicial and administrative). Some consider it an autonomous standard that incorporates principles such as transparency, good

faith, and protection of the investors’ legitimate expectations. The most recent US and Canadian BITs and a number of US, Canadian, and Mexican FTAs limit the fair and equitable treatment standard to the minimum standard of customary international law. NAFTA does not include such language but the NAFTA Free Trade Commission issued an interpretation along such lines (Box 23):

Some tribunals operating outside of NAFTA have followed a similar approach such as the

Box 23. Fair and Equitable Treatment: NAFTA

NAFTA Article 1105 reads as follows:

1. 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.

An official interpretation of Article 1105(1) has been provided by the NAFTA Free Trade Commission (FTC), a body composed of the three state parties with the power to adopt binding interpretations. The FTC Note of Interpretation of 31 July 2001 states:

Minimum Standard of Treatment in Accordance with International Law:

1. Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.
2. The concepts of “fair and equitable treatment” and “full protection and security” do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.
3. A determination that there has been a breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a breach of Article 1105(1).

Source: <http://www.sice.oas.org/trade/nafta/chap-111.asp> and <http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/nafta-alena/texte/index.aspx>

12 See UNCTAD (1998) and Fatouros (1962, 135-141, 214-215) and OECD (2004)

13 Investment treaties vary in their precise drafting. Some expressly define the standard by reference to international law: examples are treaties concluded by France, the U.S. and Canada; others do not make reference to international law, for instance, treaties concluded by the Netherlands, Sweden, Switzerland, and Germany. For example, The German model BIT states: “Each Contracting Party...shall in any case accord such investments fair and equitable treatment”; and the Swiss model BIT states: “Investments and returns of investors of each Contracting Party shall at all times be accorded fair and equitable treatment...” UNCTAD (1998 n.1)

14 OECD (2004).

15 Some authors believe that the FET standard does not incorporate the minimum standard, but rather is stand-alone. See for example, Dolzer (2005).

Tribunal in *CMS Gas Transmission Company v. Argentina*, although most of them interpreted the FET as an autonomous standard.

Box 24. *CMS Gas Transmission Company v. Argentina*

In this case the tribunal stated that:

There is one additional aspect the Tribunal must examine (...). That is whether the standard of fair and equitable treatment is separate and more expansive than that of customary international law (...), or whether it is identical with the customary international law minimum standard (...). In fact, the standard of fair and equitable treatment and its connection with the required stability and predictability of the business environment, founded on solemn legal and contractual commitments, is not different from the international law minimum standard and its evolution under customary law.

Source: *CMS Gas Transmission Company v. Argentina*, Award of May 12 2005, 44 ILM (2005) 1205.

We acknowledge that this discussion on FET can be complicated, especially for nonlawyers. To make it easier to understand, let us note that the FET standard is intended to protect investors against **discriminatory measures**. A measure would breach the FET standard when it lacks a legitimate purpose, or is otherwise unjustified, and when it has a negative effect on a foreign investor. Discriminatory measures are also often considered as arbitrary, and the two concepts have been closely associated. Some recent investment codes in developing countries, such as Liberia's, specifically prohibit discrimination.¹⁶ In *Waste Management v. Mexico*, ICSID defined FET as follows: "[T]he minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is

arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process."¹⁷

The FET standard requires host states to comply with the **due process of law** and includes the obligation not to deny justice in criminal, civil, or administrative proceedings. The standard covers proceedings before the courts of the host state. The principles of access to justice, fair procedure, and the prohibition of denial of justice relate to three stages of the

Box 25. Concept of Due Process and Its Application to Foreign Individuals

The concept of due process has been expressed by the International Court of Justice (ICJ) in the following terms:

"The foreigner shall enjoy full freedom to appear before the courts for the protection or defense of his rights, whether as plaintiff or defendant; to bring any action provided or authorized by law; to deliver any pleading by way of defense, set off or counterclaim; to engage counsel; to adduce evidence, whether documentary or oral or of any other kind; to apply for bail; to lodge appeals and, in short, to use the Courts fully and to avail himself of any procedural remedies or guarantees provided by the law of the land in order that justice may be administered on a footing of equality with nationals of the country."

Source: ICJ, *Ambatielos Claim*, 6 March 1956 (*Greece v. United Kingdom*) 23 ILR 306.

¹⁶ See <<http://www.bilaterals.org/spip.php?article11632>

¹⁷ Reinisch, August. *Fair and Equitable Treatment & Full Protection and Security Presentation* and see *Waste Management v. Mexico*, ICSID 2004

judicial process: the right to bring a claim, the right to a fair treatment during the proceedings, and the right to an adequate and enforceable decision at the end of the process.

Investment legislation should include a reference to the minimum standard of customary international law, to nondiscrimination and to the requirement of due process of law as embodied in the FET standard.

National Treatment

The national treatment standard seeks to ensure a degree of competitive equality between national and foreign investors. It dictates that a host country must extend to foreign investors treatment that is at least as favorable as the treatment it accords to national investors in like circumstances. That is, the state will treat foreign and domestic investments alike and shall not discriminate against foreign investors.

National treatment is a principle embodied in numerous national laws, in particular in many host-country investment laws. It is also recognized in many bilateral and multilateral treaties, such as bilateral investment treaties, NAFTA, the Energy Charter Treaty, as well as WTO and OECD instruments.

National treatment also applies on the subnational level. National treatment obligations are applicable to the host-country government and its agencies, but in practice it is not always clear what national treatment means for the political subdivisions of a state. This issue is significant when a subnational authority has the constitutional power to determine investment policy. Such power may be used to grant preferential treatment to local investors as, for example, where a host subnational authority seeks to encourage the growth of SMEs. The question that arises is

whether a subnational authority (for example, a state) has to extend special treatment to foreign investors on the basis of the national treatment standard regardless of how it treats domestic investors from outside its jurisdiction. For example, U.S. subnational authorities (states) are to treat foreign investors like those from other U.S. states, in compliance with national treatment obligations. If the host state offers preferential treatment to local investors and not to investors from other U.S. states, the foreign investor cannot invoke national treatment to obtain the local preferences. All that the foreign investor can do is to require treatment no less favorable than that accorded to investors from other U.S. states.

The national treatment standard eliminates distortions in competition and enhances the efficient operation of the economy. However, no country has granted national treatment without exception, for reasons of national security and

Box 26. Example of Violation of National Treatment: Ecuador

Occidental Exploration and Production Company (OEPC), a U.S. company, entered into a participation contract with Petroecuador, a state-owned Ecuadorian corporation. OEPC applied for the reimbursement of the value-added tax (VAT) it had paid on the purchases required to fulfill its terms of the contract. The government refused to reimburse OEPC for the amount of VAT paid.

OEPC claimed this was a violation of the BIT between the United States and the Republic of Ecuador, which incorporates the principle of national treatment. Because all other exporters were entitled to VAT refunds, the arbitral tribunal concluded that the Republic of Ecuador, in denying reimbursement to OEPC, had violated the principle of national treatment.

Source: London Court of Arbitration, Final Award in the Matter of a UNCITRAL Arbitration: Occidental Exploration and Production Company v. The Republic of Ecuador – Case No. UN 3467, July 1, 2004.

others. A number of host nations discriminate at least to some extent for reasons such as: (i) controlling strategic assets in the national interest; (ii) defending national sovereignty in economic matters; (iii) stimulating the development of local industries; and (iv) upholding issues of public policy, public health, and public morality. These competing concerns – attracting investment with investor protection vs. protecting certain economic sectors – sometimes makes national treatment a difficult standard to achieve. Nevertheless, it remains the most effective standard to establish a level playing field between national and foreign investors.

Good practice: The good practice is for the investment policy and legislation to grant to all foreign investors in relation to the establishment, expansion, management, operation, and protection of their investments treatment “no less favorable” than that granted to national investors in like circumstances.

Most-Favored-Nation Treatment

A variation of the principle of nondiscrimination is the MFN treatment. MFN treatment requires a host country to treat investors from a given foreign country no less favorably than investors from any other foreign country (that is, countries cannot discriminate between foreign investors). If a country grants investors from a specific country a special favor such as a lower customs duty rate for imports, it has to grant the same for all other foreign investors.

Foreign investors seek sufficient assurance that there will be no discrimination that puts them at a competitive disadvantage. Such discrimination includes situations in which competitors from other foreign countries receive more favorable

treatment. The MFN standard helps to establish equality of competitive opportunities between investors from different foreign countries. It prevents competition between investors from being distorted by discrimination based on nationality considerations. The more foreign investors from different countries play an important role in a host country, the more important the MFN standard becomes. Equality of treatment based on the MFN standard should be included in the investment legislation of host states.

The MFN standard guarantees investors protection from certain forms of discrimination by host countries, and it is at the heart of multilateralism. The standard is widely used in international trade and investment, and should be incorporated into national investment laws.

The MFN standard potentially applies to all kinds of investment activities, such as the establishment, operation, management, use, sale, or liquidation of an investment. This comprehensive coverage ensures that foreign investors are protected even if the investment-related activities change or expand during the lifetime of their investments. Moreover, the standard can be invoked with regard to any investment legislation, regulation, or administrative practice.

It must be noted, however, that the MFN standard does not cover all host-country treatment of foreign investors. If a host country grants special privileges or incentives to an individual investor in an investment contract, the MFN standard does not oblige the country to grant those privileges to all foreign investors, because a host country cannot be obliged to enter into a specific investment contract. Only if the host country makes this targeted behavior general practice – for example, if it grants an incentive under a general subsidy program – would the MFN standard apply. It is worth mentioning in this regard that it is not good practice to have host countries enter into specific

investment contracts to grant investors special privileges and incentives.

Investment laws frequently contain exceptions to the MFN standard. There are exceptions of a general nature (not specifically limited to the MFN provision) for reasons of public policy or national security, or for the maintenance of public order or public health. More specific exceptions relate to taxation, intellectual property, or the existence of free trade areas, customs unions, or Regional Economic Integration Organizations (REIO). REIO members are generally exempted from the obligation to grant MFN treatment to nonmembers. The purpose of such exceptions is to allow members of a regional union to advance their internal investment liberalization at a faster pace than that to which nonmembers have agreed.

Guarantees Against Expropriation

Investors face economic risks that result from political activities in a country. The threat of interference, over-regulation, or expropriation can dissuade them from investing at all, or cause them to demand higher than normal rates of return in compensation. The right to expropriate property is a sovereign right of a state, and it is perceived as one of the main political risks by all investors. To attract investment and reduce costs, governments need to take steps to reduce such risks.

Expropriation has two aspects:

- It is a measure attributable to a state, its legislative, executive, or judicial organs;
- It leads to a transfer of property rights. The beneficiary of this transfer is not always the state itself, as evidenced by land reform programs.

As explained later, one of the main issues related to the direct expropriation is the level of compensation which should be “prompt and adequate.” If there is no compensation, it is “unlawful expropriation.”

Expropriation may be direct or indirect.

Direct Expropriation

Direct expropriation occurs “when the ... State takes property owned by an investor located in the ... State, when there is deprivation of wealth attributable to the State.”¹⁸

A sensitive question that arises is whether nationalization measures should be treated differently, or submitted to a legal regime identical to expropriation. Nationalization refers in most cases to wide-ranging socioeconomic reforms, while expropriation is often applicable to individual measures.¹⁹ The 20th century witnessed many instances of nationalization, in Latin America (starting with the Mexican revolution of 1910), Eastern Europe (after 1917 and 1945), China (after 1949), and the Middle East (the Arab Republic of Egypt (in 1956) with the nationalization of the Suez Canal, and the Islamic Republic of Iran (in 1951) with the nationalization of the oil industry). During the past two decades, nationalizations have declined, and investors have a greater sense of confidence, although the threat of nationalization still exists in certain regions. For instance, Bolivia nationalized the oil and gas sector as recently as 2006, and in República Bolivariana de Venezuela, President Hugo Chavez has announced plans for nationalization in many

¹⁸ SICE Foreign Trade Information System, *Dictionary of Trade Terms*. “Investment”.

¹⁹ In general expropriation applies to individual measures taken for a public purpose while nationalization involves large-scale takings on the basis of an executive or legislative act for purpose of transferring property or interests into the public domain. See Dolzer and Stevens (1995, 98, reference 263).

sectors such as telecommunication, oil, banks, and steel. It has frequently been argued that nationalizations had specific characteristics that resulted in their settlement through lump-sum payments and intergovernmental agreements. In other words, the legal conditions applicable to nationalizations would be substantially different from those applicable to expropriation. We are clearly opposed to such a differentiation, and agree with the recent evolution of the main legal systems, both at national and international level, to apply the same conditions to expropriation and to nationalization measures.

Box 27. Example of Direct Expropriation: Egypt Arab Rep. of

Wena, a British company, owned two hotels in the Egypt. In 1991, the hotels were forcibly attacked and seized by government order. The Egyptian government offered no compensation. Wena claimed that Egypt violated the U.K. and Egypt Investment Promotion and Protection Agreement prohibiting expropriation without compensation. The arbitral tribunal held that Egypt had refused to compensate Wena for the loss of its investment and concluded that Egypt had violated the agreement.

Source: Wena Hotels Ltd v. Arab Republic of Egypt, ICSID, Case No. ARB/98/4 (December 2000)

Indirect Expropriation

Indirect expropriation is the most usual form of expropriation today. Indirect expropriation occurs when the state interferes in the use of the investor's property or the benefits, even where the property is not seized and the title of property is not affected, for instance, when governmental measures force an investor to flee the country, deny him access to his funds or profits, or compel him to sell or transfer at an unfairly low price (Rosenn 1998, 10). While in direct expropriation, the loss of ownership of the investor and the

appropriation by the state are linked, this is not the case in indirect expropriation (OECD 2004, 3-4). The state power of regulation in fiscal, monetary, environmental, and other matters could convert into a "regulatory taking" of property.

A basic distinction between the right of a state to expropriate and its regulatory power (or "police power") is that expropriation implies compensation, while the exercise of regulatory/police power does not, except when the effect of a regulatory measure is equivalent to an expropriation. The number of reports on cases of indirect expropriation, such as fiscal measures of a confiscatory nature, blocking of funds transfer, or substantial interference in the management of an enterprise, has increased significantly during the last two decades. The determination of an indirect expropriation requires a factual and case-by-case appraisal. Canada, in investment agreements concluded with other countries, provides a definition of an indirect expropriation, as seen in Box 28.

Box 29 gives an example of indirect expropriation.

Good practice: Good practice policy and legislation does not mean the government promises not to expropriate. Every government may encounter national imperatives that require it to expropriate private property – domestic or foreign, individual or corporate. Good practice in investment policy and legislation is to guarantee that the government will not expropriate or take measures that will have a similar effect, **except for a public purpose**, and on a **nondiscriminatory basis**, in **accordance with laws and procedures** ("due process") and subject to the **prompt payment of adequate and effective compensation**.²⁰ This

²⁰ The Hull Rule of *adequate, prompt and effective* compensation is seen by many as the best practice in this regard. Some countries do resist its introduction (in full or in part) on various grounds, and there is extensive literature on this issue of compensation and the meaning of each of these terms.

Box 28. Definition of Indirect Expropriation: Canada's Model Foreign Investment Protection Agreement

- (a) "Indirect expropriation results from a measure or series of measures of a Party that has an effect equivalent to direct expropriation without formal transfer of title or outright seizure;
- (b) The determination of whether a measure or series of measures of a Party constitutes an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors:
 - (i) the economic impact of the measure or series of measures, although the sole fact that a measure or series of measures of a Party has an adverse effect on the economic value of an investment does not establish that an indirect expropriation has occurred;
 - (ii) the extent to which the measure or series of measures interferes with distinct, reasonable investment-backed expectations; and
 - (iii) the character of the measure or series of measures;
- (c) Except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith, nondiscriminatory measures of a Party that are designed and applied to protect legitimate welfare objectives, such as health, safety and the environment, do not constitute indirect expropriation."

Source: <http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/nafta-alena/texte/index.aspx>

principle includes direct expropriation. The objective is to protect investors against the risk of abuse.

This guarantee should be stated clearly in a country's legal framework. If the Constitution, an administrative code, expropriation act, or other vehicle details the expropriation and compensation process, the investment law need not restate them; its reference to the key principles upheld

by the state should suffice to reassure investors. If other pieces of legislation do not spell out the details, then the government needs to develop such a law to fill an important gap that no investment code, however well drafted, can fill.

An additional feature of the concept of expropriation is compensation. Expropriation without compensation is confiscation. However, not every confiscation is illegitimate. For instance, confiscation of the property of a convicted criminal by a judicial authority, or of goods fraudulently imported into a country is legitimate, but it remains outside the field of expropriation.

As stated above, the features of legitimate expropriation are nondiscrimination; for the public good; in accordance with due process; and

Box 29. Metalclad Corp. vs. United Mexican States

Metalclad Corp, a U.S. company, alleged that local Mexican officials took measures interfering with Metalclad's development and operation of a hazardous waste landfill by ordering the cessation of all building construction for lack of a municipal construction permit.

Thirteen months after this permit application was filed, it was denied by the municipality. Because Metalclad had not had the opportunity to participate in the deliberation process, the company claimed a violation of NAFTA, stating the prohibition of indirect expropriation without compensation.

Several months after the proceeding began, the governor of the Mexican region declared the contentious landfill a "natural area." The arbitral tribunal held that the exclusive authority for permitting a hazardous waste landfill resided with Mexico's federal government, and that the municipality had acted "outside its authority." The tribunal therefore concluded that Mexico had violated its NAFTA obligation by indirectly expropriating Metalclad's investment without providing compensation.

Source: *Metalclad Corp. v. United Mexican States*, ICSID, Case No. ARB (AF)/97/1 (August 30,2000).

accompanied by the payment of prompt, adequate, and effective compensation. Concepts used in the discussion above may be further explained as follows:

- **Nondiscriminatory:** The expropriation will be on a nondiscriminatory basis if it is not motivated by the investor's nationality political attribution or gender.

The nondiscrimination rule applies to expropriation. This has been recognized throughout the 20th century, and recent international case law has confirmed its validity. For instance, in the Libyan nationalization case, during the early 1970s, the government of Libya justified the nationalization of the British Petroleum (BP) concession as a reprisal against British failure to prevent Iran, Islamic Rep. of from occupying three islands in the Persian Gulf, which were officially under British protection. The arbitral tribunal determined that the BP nationalization had a discriminatory character, based on the foreign investor's nationality.

- **Public purpose:** Any expropriation or nationalization should be undertaken for a public purpose. In many countries, national courts rely on elaborate case law to determine the definition, scope, effects, and limits of the public purpose requirement.
- **Due process of law:** This requirement implies access to justice, a fair procedure, and the prohibition of a denial of justice throughout the judicial process.
- **Compensation:** A major issue in cases of expropriation or nationalization is the amount of compensation due to investors. National investment law uses the terminology "adequate," "just," or "fair and equitable." Compensation is adequate if it reflects the fair market value of the asset just before the

taking happens or the decision to take it is publicly known (it should not reflect any change in value occurring because the intended expropriation had become known earlier). According to the World Bank guidelines, "fair market value" is acceptable if it is derived from a method agreed by the state and the investor or by a tribunal or other body designated by the parties (WBG 1993). Fair market value is the price that a willing buyer would pay to a willing seller under regular market conditions. If the investment had been listed on a stock exchange, the value of the corporate capital is likely to be assessed without major difficulties. But, in many cases, market conditions are not so easy to determine. In contemporary practice, courts and tribunals often use the "discounted cash flow (DCF) method." Such method is particularly accurate for evaluating an enterprise as a going concern, or the value of concessions or other investment contracts. Another method, generally more conservative, is based on the "book value" or the asset value of the enterprise. This method is widely used by fiscal authorities and by auditing firms. To reduce uncertainties, judicial and arbitral experts often resort to a combination of methods to assess the value of the investment.

Moreover, compensation should be determined in a **prompt** manner. This requirement refers to two different time periods. First, the payment of the compensation should take place without unjustified delays. Second, in case of delay, interest should be allocated to the investor, based on the applicable market rate or on the legal rate, depending on the country. Note that any deferred methods of payment, such as bonds, are not considered as prompt payment.

Finally, compensation should be paid in an **effective** way. This refers to the modality of payment, and it covers two different aspects. An effective payment should be made in cash, in a

freely convertible currency (or currency acceptable to the investor) that the investor may use to service debts and liabilities and a foreign investor may transfer abroad. If compensation takes in the form of financial instruments such as Treasury bonds, the instruments should be negotiable on the financial market and bear a market rate of interest.

Convertibility and Repatriation

Conditions for the transfer of funds by foreign investors out of the host country are a major concern for both the investor and the state. Repatriation of profits and capital into the home country will be a primary objective of the investor. The host state needs to preserve its currency and its foreign reserves. Consequently, the interests of the foreign investor and those of the host state in the management of foreign transfers often diverge.

An increasing number of investment laws recognize the principle of “freedom of transfer” applicable to foreign investments. It implies a commitment from the host state to guarantee to foreign investors convertibility and repatriation.

- **Guarantee of convertibility into freely convertible currency:** The right to convert local currency into freely convertible currency should be guaranteed to an investor. Investment laws and regulations should specify the monetary provisions applicable to the transfer of funds. Payment should be in a convertible currency or, in International Monetary Fund (IMF) terminology, a “freely usable” currency. The exchange rate should be the market rate, where it exists, or the official rate of exchange as determined on the date of transfer. A foreign investor should not be compelled to repatriate the funds; it

should also be able to transfer funds to another country. Access to foreign exchange is important in that it enables businesses to pay the costs of imports and other foreign obligations, such as management, royalty or license fees, foreign travel, expatriate costs, and debt service obligations and to repatriate profits and capital. This right should not be restricted by the form of investment, nor restricted by the purpose of the conversion. An investor may have to meet certain conditions to make these transfers (such as payment of taxes before profits are remitted), but there should be no other restrictions on these transfers.

However, it is worth noting that investment laws should ideally guarantee the access, convertibility, and transfer of foreign exchange but not the availability as it is subject to macro economic factors and balance of payment considerations.

- **Guarantee of repatriation:** This guarantee will enable an investor to transfer abroad their profits, dividends, and other funds swiftly and without restrictions (repatriation clause). Before investing in a given country, foreign investors, in particular want assurances that they will be able to transfer funds (profits, dividends, products of liquidation, sale, compensation, and so forth) overseas in the currency of their choice. In addition, foreign employees should also be free to transfer their salaries and savings without delay. The principle is not compatible with the imposition of restrictions or undue delays on the transfers. However, a foreign investor needs to comply with technical and administrative modalities for the transfer of funds, so long as they do not have a restrictive effect.
- **IMF authorization.** The free transfer of funds will meet a major challenge in exceptional financial or economic

circumstances, such as a balance of payment crisis and exhaustion of foreign reserves. The host state may take measures to safeguard the integrity of its national currency, which could restrict an investor's transfer of funds. If such an exception is provided in the host country's laws, it is crucial to qualify it. Such exceptional measures should remain consistent with the rights and obligations of the host country as an IMF member.

With regard to foreign investments, a basic distinction is made in the IMF Articles of Agreement between international current transactions and capital movements. According to Article VIII(2)(a), no member shall impose restrictions on payments concerning current transactions without authorization of the IMF. Most countries today, including many developing and transition countries, have to comply with this requirement. Current transactions include net income from foreign investments and payments of a reasonable amount resulting from provisions for depreciation of FDI. However, IMF members are allowed to regulate international capital movements, which include the repatriation of capital, although in practice the IMF has not encouraged the adoption of restrictive measures on capital movements. Therefore, according to the IMF rules, the transfer of funds resulting from many foreign investment operations should not be restricted; and, if restrictions are implemented, they should be authorized by the IMF.

- **Categories of transfers:** Transfers that should not be restricted include income from foreign investments, that is, dividends and profits, interest paid on loans, and payments derived from intellectual property rights, such as royalties and technical assistance fees. The reimbursement of loans often depends on an authorization of monetary authorities, which could be granted

when loans are contracted. More restrictions frequently apply to the repatriation of capital. In a number of investment laws, a minimum period of time is scheduled between the date of the initial investment and the date of a possible repatriation of capital. Time periods of two to five years are not unusual. Moreover, the amount of capital allowed to be repatriated is often a delicate issue. The repatriation of capital should include the initial amount of capital invested, and reinvestments in the enterprise, as well as capital gains obtained in the process of liquidation. But a number of countries impose restrictions on the amount to be repatriated, and some of them limit it to the capital initially registered with the foreign investment agency or the central bank. Similarly, salaries and other remuneration of foreign directors, senior managers, and expatriates often include limits on repatriation with additional requirements that a percentage of their remuneration is spent in the host country.

The repayment of loans contracted by investors may be guaranteed by the central bank or other financial institution of the host country. In such a situation, the central bank provides the assurance that the necessary amount of foreign currency will be made available for the repayment of the loan (or other obligations), and that the transfer of such amount abroad will be ensured. Such legal guarantees take the form of letters from the central bank to investors, or of "transfer clauses" in contracts between the host state and investors.

- **Good practice:** To encourage investment, a host country should minimize the restrictions upon the free transferability of funds. Its investment law (or other legislation) should then guarantee the free and prompt transfer of funds related to foreign investment, such as profits, dividends, royalties,

loan payments, and liquidations, in a freely convertible currency of the investor's choice. Exceptional measures should be consistent with the host state's obligations as a member of the IMF.

Settlement of Disputes

An investment dispute between a host state and an investor can be settled by the host state's courts. This is however not the solution preferred by most foreign investors, because they fear a lack of impartiality from those courts. In a number of countries, an independent judiciary system cannot be taken for granted and executive interventions in court proceedings are likely to influence the outcome of a lawsuit, especially where substantial financial amounts are at stake.

Ordinary courts also often lack the expertise to deal with highly technical issues in investment disputes. The courts of the foreign investor's home country or of third states are usually not an option, because they lack territorial jurisdiction over investments that take place in a foreign country. For these reasons, alternative methods have been developed for the settlement of disputes, granting an investor direct access to international arbitration with the host state. As such, investors should have the right to resort to conciliation and international arbitration to settle certain classes of disputes with the host-state or domestic firms. Investors are concerned with timely settlement of claims and awards.

- **Conciliation and mediation.** In most cases, the method selected for the settlement of investment disputes is arbitration. Alternative or complementary methods are conciliation and mediation, which are more informal and flexible. Conciliation and mediation are designed to assist the parties in reaching an

agreed settlement. They take place before a conciliator, a conciliation commission, or a mediator that examines the facts and drafts a report proposing a solution that is not binding on the parties. The solution proposed eventually depends on an agreement between the parties. Conciliation and mediation are seldom used, mainly because they are not an authoritative procedure. The difference between conciliation and mediation is that the conciliator may recommend to the parties how the dispute should be resolved whereas the mediator facilitates the communication and decision-making of the parties without making any recommendation. Sometimes, conciliation and mediation procedures are provided as a prerequisite for arbitration. This is not recommended because it might delay the process and be used by the host state in a discretionary and arbitrary way.

- **Arbitration.** Arbitration is an adversarial procedure that leads to a binding decision founded on legal grounds. The establishment of an efficient and effective arbitration system is likely to have a preventive impact and a restraining influence on investors and host states. The "threat" to take a government to arbitration may be sufficient deterrent for the government not to be careless about its treatment of investors. Both parties will try to avoid measures that might lead to an arbitration that they would lose, and their willingness to settle a dispute through negotiations will be strengthened. Several institutions and systems are available to establish international arbitration proceedings (Box 30).
- **Consent to arbitration.** Investment arbitration is always based on an agreement. In practice, consent to arbitration may be given through three different methods.

A first way to give consent is a provision in

Box 30. List of Key Institutions and Systems in which Establish International Arbitration Proceedings Can be Undertaken

ICSID

Many cases today take place within the framework of the Convention on the Settlement of Investment Disputes between states and nationals of other states, adopted in Washington in 1965, which established the ICSID Convention (or Washington Convention). 144 states are parties to the ICSID Convention. The purpose of the Convention is to remove major impediments to the free international flows of private investment posed by noncommercial risks and the absence of specialized international methods for investment dispute settlement. ICSID was created by the Convention as an impartial international forum providing facilities for the resolution of legal disputes between eligible parties, through conciliation or arbitration procedures.

ICSID jurisdiction requires an investment dispute of a legal nature between a state party to the Convention and a national of another state that is also a party to the Convention. Moreover, the two parties to the dispute must have consented to ICSID jurisdiction. National courts have no power to stay or to influence ICSID proceedings, nor to review or to set aside ICSID awards. The lack of cooperation of a party will not stall the proceedings, and it will not affect the award's binding force and enforceability.

ICSID Additional Facility Rules

The additional Facility Rules were established in 1978, and apply in cases where either the host state or the investor's home state is not a party to the ICSID Convention. It has become important in the context of NAFTA, because the United States has ratified the ICSID Convention, but not Canada and Mexico. The provisions of the ICSID Convention on the recognition and enforcement of awards are not applicable to awards decided under the additional facility. Moreover, unlike ICSID awards, awards rendered under the additional facility are not exempted from the scrutiny of national courts.

United Nations Commission on International Trade Law Rules

The 1976 version of the rules of arbitration of the United Nations Commission on International Trade Law (UNCITRAL), provide a procedural framework but do not institute a mechanism to administer proceedings. The parties may wish to request an institution to provide an administrative framework for a case, or they could establish an ad hoc tribunal with no institutional support. Any arbitration institution, such as ICSID, London Court of International Arbitration (LCIA), Stockholm Chamber of Commerce (SCC), International Chamber of Commerce (ICC), or Permanent Court of Arbitration (PCA) could administer disputes under the UNCITRAL rules upon the request of the parties. The UNCITRAL rules address all matters arising in international proceedings, from the notice of arbitration to the appointment of arbitrators, interim measures, the rules governing the proceedings, and the form and effect of an award. UNCITRAL has also influenced the development of national legislation through the UNCITRAL Model Law on International Commercial Arbitration (1985). The UNCITRAL Rules are being reviewed and the amendments are likely to take effect in 2011.

International Chamber of Commerce

Its current rules date from 1998 and are currently being reviewed. A major role is played by the "International Court of Arbitration," which is an administrative body composed of representatives from different countries. Once an arbitral tribunal has agreed on a draft award, it is forwarded to the ICC Court, which checks it to ensure that all relevant matters are covered and that no obvious errors appear in the draft. However, the responsibility for the final substance of the award remains with the tribunal and not with the court.

Other institutions

In addition to ICSID, several institutions are involved in investment arbitration. Institutions dealing traditionally with commercial arbitration such as the LCIA, ICC, and SCC administer some investor-state cases.

Source: IC research

the investment legislation of the host state. Many developing and transition countries have adopted such provisions. However, not every reference to investment arbitration in national legislation amounts to consent to jurisdiction.

A number of national investment laws provide clearly for dispute settlement by international arbitration. For example, Albania's Law on Foreign Investment (2002) states in Article 8(2) with respect to expropriation: "... the foreign investor may submit the dispute for resolution and the Republic of Albania hereby consents to the submission thereof, to the International Centre for Settlement of Investment Disputes." Other provisions are less explicit but still express the state's consent to international arbitration. National laws may state that a dispute "shall be settled" by international arbitration.

Other references to investment arbitration in national legislation may not amount to consent. Some provisions make it clear that further action by the host state is required to establish consent. This would be the case where the law provides that the parties "may agree" to settle investment disputes through arbitration. Moreover, a legislative provision containing consent to arbitration is merely an offer from the state to foreign investors. An investor must accept the offer in writing at any time while the legislation is in force, and its acceptance may also be made by instituting proceedings. It is recommended to include in the investment law an arbitration provision with an explicit consent to arbitration that will give investors more comfort.

Second, an agreement between the parties recording consent to arbitration may also be achieved through an arbitration clause in an investment contract between the host state and the investor. In other instances, the agreement on consent between the parties

may not be recorded in a single instrument such as when an investment application made by an investor provides for arbitration and is later approved by the competent authority of the host state at which point it will be considered as a consent to arbitration by both parties.

The third technique to give consent to arbitration is through a treaty between the host state and the investor's state of nationality. Most BITs contain provisions offering arbitration to the nationals of one state party to the treaty against the other state party to the treaty. The same method is used in a number of multilateral treaties such as NAFTA and the ECT. Offers of consent contained in treaties must also be supplemented by an acceptance on the part of the investor.

A common condition for the institution of arbitration proceedings is that an amicable settlement has been attempted through consultations or negotiations. This requirement is subject to time limits ranging from three to 12 months. If no settlement is reached within such a period, the claimant may proceed to arbitration.

In general, provisions giving consent to investment arbitration do not require the exhaustion of local remedies before international proceedings are instituted. The ICSID Convention in Article 26 excludes the requirement to exhaust local remedies. However, some instruments provide that before an investor may bring a dispute before an international tribunal, it must seek its resolution before the host state's local courts for a certain period of time, often 18 months. The investor may proceed to international arbitration only if the domestic proceedings do not result in a dispute settlement during that period or if the dispute persists after the domestic decision. This is not recommended

and will not give investors enough guarantees because it may delay the process for at least 18 months (where the time is capped) and may be used by the host state in a discretionary and arbitrary way.

- **Applicable law.** The parties to a dispute may agree on the governing law. A number of investment contracts refer to a host state's law but in the majority of cases, agreements between the parties on applicable law include international law as well as host state law.

A number of international instruments contain their own choice of law clauses when there is no agreement on applicable law between the parties. Box 31 contains an example.

Box 31. Applicable Law under the ICSID Convention

The ICSID Convention Article 42(1) states: The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable.

Source: ICSID Convention, Regulations and Rules

The UNCITRAL rules and the ICC rules stipulate that a tribunal will apply the law designated by the parties. If there is no choice of law clause, the UNCITRAL rules refer to “the law determined by the conflict of law rules which (the tribunal) considers applicable” and to “the usages of the trade applicable to the transaction” (Article 33). The ICC rules provide that the tribunal “shall apply the rules of law which it determines to be

appropriate” and that it “shall take account of the provisions of the contract and the relevant trade usages” (Article 17).

As stated above, in most cases, the applicable law in investment arbitration combines the host-state law and international law. Tribunals have applied both systems of law. Where there has been a contradiction between the two, international law had to prevail.

- **Review of decisions.** Awards are usually not subject to any appeal procedures. It is only under limited circumstances that a review of awards may take place.

In non-ICSID arbitration, including arbitration under the additional facility, the way to challenge an award is through national courts. The UNCITRAL Model Law on International Commercial Arbitration (1985) provides a limited number of grounds for the nonrecognition of an international arbitration award by a national court (similar to Article V of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958). In many countries, national arbitration laws follow the pattern of the UNCITRAL Model Law.

ICSID awards are not subject to annulment or any other form of scrutiny by national courts. The ICSID Convention includes its own review system, under which, an ad hoc committee may annul an award upon the request of a party. Annulment is different from appeal; it is concerned only with the legitimacy of the process of decision but not with its substantive accuracy. The grounds for annulment are listed in Article 52(1): that the tribunal was not properly constituted; that it has manifestly exceeded its powers; that there was corruption on the part of a member of the tribunal; that there has been a

serious departure from a fundamental rule of procedure; or that the award has failed to state the reasons on which it is based. Annulment is restricted to these five grounds, which are mainly of a procedural nature.

- **Enforcement of awards.** Arbitral awards are binding upon the parties and create an obligation to comply with them. The enforcement of non-ICSID awards is subject to the national law of the place of enforcement and to the New York Convention of 1958. The ICSID regime is different. Under Article 54 of the ICSID Convention awards are to be recognized as binding and their pecuniary obligations are to be enforced like final domestic judgments in all state parties to the convention. Proceedings for the recognition and enforcement of ICSID awards may be initiated in several states simultaneously. Under Article 55 of the ICSID Convention, the obligation to enforce the pecuniary provisions of an award does not affect the immunity from execution that states enjoy. In this context, a distinction is usually made between commercial and noncommercial property. Execution is permitted against commercial property but not against property serving official or governmental functions.
- **Good practice:** Good practice is for the investment code to recognize/guarantee that disputes arising in connection with investment or the interpretation of the law will be settled promptly through consultations and negotiations between the parties to the dispute, or through procedures for arbitration in accordance with the host country's international commitments or through other arbitration procedures acceptable to both parties. It is not advisable to include in the provision a mandatory period of negotiations before filing for arbitration.

Other Provisions

A number of investment laws include specific provisions on the following topics: boards of directors, entry of personnel, state enterprises and monopolies, and armed conflicts and civil disturbances.

Boards of Directors, Senior Management, and Entry of Personnel

A host country should not require that an enterprise appoint to senior management positions individuals of any particular nationality, and in particular nationals of the host state. But in a number of countries, nationality requirements apply to members of the boards of directors and of committees operating under the designation of the boards. Where the law requires that a percentage or the majority of the board of directors be nationals of the host state, or resident in the territory of the host state, it is essential that this requirement does not materially impair the ability of the investor to exercise control and its management prerogatives over its investment.

Immigration laws and policies may restrict the entry of foreign personnel needed to manage an enterprise. Therefore, it may be appropriate to include in an investment law a specific provision stipulating that a host state shall grant the necessary permits to foreign nationals employed by an investor in a capacity that is managerial or executive or requires specialized knowledge and expertise, subject to the laws, regulations, and policies of the host state relating to the admission of aliens.

Host states should be encouraged to facilitate the entry of foreign nationals needed to efficiently run an investment enterprise.

Box 32. The AAPL v. Sri Lanka Case

In AAPL v. Sri Lanka, the government of Sri Lanka was held responsible for an attack conducted by its military forces against the foreign investor's enterprise in the context of antiterrorist activities. In the arbitral tribunal's opinion, the state authorities should have undertaken precautionary measures before launching an armed attack against the foreign investor's premises.

Source: AAPL v. Sri Lanka, Award, 27 June 1990, 30 ILM (1991) 577.

State Enterprises and Monopolies

State enterprises often exercise regulatory, administrative, or other governmental authority that a host state has delegated to them. Such powers include the right to expropriate, to grant licenses, to approve commercial transactions or to impose quotas, fees, or other charges. In their relations with investment enterprises, it is crucial that state enterprises observe the same standards of treatment as the host state (fair and equitable treatment, national treatment, and MFN treatment). The same standards should also apply to any privately owned monopoly designated by the host state or any government monopoly that it maintains.

Armed Conflicts and Civil Disturbances

Investors are aware that in the course of long-term investment projects extraordinary events may occur, such as periods of economic and social disorder, civil strife, armed conflict, or

natural disaster. In international law, the basic principle has been the nonresponsibility of the host state toward investments, and foreign investments in particular, for events of social strife or armed conflict. Nevertheless, this principle is qualified by an obligation of the host state to exercise due diligence, and to use the police and the military forces to protect investments to the extent feasible under the circumstances (Box 32).

Some investment laws include provisions dealing with compensation for losses incurred by investors owing to civil strife, armed conflict, or a natural disaster. The applicable standards should be national treatment and MFN treatment when it comes to compensation programs adopted by the host state to deal with the consequences of emergency situations.

Conclusion: A "good" investment law could be limited to the core guarantees described in the sections above. Some other matters can be included, and are often included, such as the entry and employment of expatriate workers (including their treatment under social security, health, and other wage taxes), access to land, protection of intellectual property rights, right to transfer property, right to establish branches and subsidiaries, and rights to borrow, and obtain insurance from abroad.

Particular attention should be paid by policy makers to this section of an investment law because the success or failure of an investment law is usually attributable to the rights and protections accorded to investors.



CHAPTER 6: INVESTMENT INCENTIVES

We discuss the issue of incentives in the handbook because many countries have utilized the investment code to offer and organize investment incentives.

Countries, regional entities, and cities have used investment incentives to attract investment. These typically take the form of measurable economic advantages afforded to individual enterprises or categories of enterprises in order to steer investment into favored sectors and/or regions, or to influence the character of investments made in a country. Some incentives have also taken the form of loans and rebates to support business development and enhance competitiveness.

The broader issue of the value of investment incentives is a highly complex one that needs a

more comprehensive analysis than this handbook can undertake. The handbook limits itself instead to the treatment of investment incentives in the context of the reform of investment regimes. For additional information and analysis on investment incentives, please refer to the reports and papers referenced in this section and prepared by the World Bank, IMF, IC,²¹ the OECD, and others (OECD 2003).

It is important to note from the outset that incentives should ideally not be provided in the investment code but by substantive laws (tax, customs etc.). Investment laws may, however, refer to such laws as necessary.

²¹ See for instance, James (2009) and Wells, Allen, Morisset, and Pirnia. (2001).

Definition

Investment incentives can be defined as “measurable economic advantages that governments provide to specific enterprises or groups of enterprises, with the goal of steering investment into favored sectors or regions or of influencing the character of such investments. These benefits can be fiscal (as with tax concessions) or nonfiscal (as with grants, loans, or rebates to support business development or enhance competitiveness) (James 2009).”

Types of Investment Incentives

Although investment incentives are often popular with investment promotion authorities, some government officials and political class, they are typically viewed unfavorably – and for good reason – by tax authorities. Commonly within a country, there may be debates about the usefulness and efficiency of investment incentives. On one side of the debate will be the tax and finance authorities, which are concerned about the fiscal costs, while on the other side will be the IPIs, which see incentives as very useful marketing tools. There is a strong political economy dimension to this debate and national policymakers may need to decide on the balance to strike. This points to the strong political economy dimension of their usage (IC 2009a).

Investment incentives can be regulatory, financial, or fiscal and it should be noted that some regulatory and financial investment incentives have a fiscal aspect while others do not. The usual investment incentives employed in developing countries are as follows:

(a) Regulatory investment incentives (IC 2009a) (that is, exemptions from specific rules and regulations). These include:

- Easing of environmental requirements
- Exemptions from certain labor requirements

(b) Financial investment incentives (IC 2009a). These include:

- Infrastructure subsidies
- Job-training subsidies
- Relocation and expatriation support
- Administrative assistance
- Temporary wage subsidies such as:
 - Credits to investors
 - Real estate subsidies
 - Direct and indirect cost participation (for example, marketing, development, operating, supply of goods, and supply of services)

(c) Fiscal investment incentives (IC 2009a), which can include:

- Reduced corporate taxation, particularly:
 - Reduced rates of corporate income tax
 - Tax holidays
 - Special tax-privileged zones
- Incentives for capital formation such as:
 - Special investment allowances (for example, accelerated depreciation, enhanced deductions)

- Investment tax credits
- Allowances on reinvested profits
- Reduced impediments to cross-border operation such as:
 - Exemption from Withholding tax
 - Exemption from trade taxes (for example, reduced import and export taxes and customs duties)
 - Exemption or lowered taxation of employees (for example, lower personal income tax, social security reductions for expatriate executives and employees)
- Other tax reductions (lower sales tax, VAT reductions, property tax)

(d) Non-tax Incentives – Investor aftercare

- Ensure existing investors are properly taken care of as they are likely to be the first investors to expand investments
- Improve business and government engagement to quickly identify bottlenecks to expand investments

As stated above, this chapter does not evaluate each type of investment incentive. It seeks however to draw attention to some of the drawbacks for the fiscal investment incentives described below.²²

²² Various WBG teams have made evidence-based observations from their experiences in evaluating fiscal incentives around the world. These comments, which are summarized below, do not necessarily reflect the official view of the WBG.

Summary Analysis of Fiscal Incentives

From their experiences in performing evidence-based evaluations of fiscal incentives around the world, various IFC and World Bank teams have made a number of observations which are summarized below:

Tax Holidays (IC 2009a)

A tax holiday is an incentive that, completely or partially, exempts investment income from taxation for a specified number of years. Tax holidays are very popular although their effectiveness at attracting investment is debatable at best. Their “attractiveness” is attributable to (i) their simple design and (ii) the fact that the government does not incur out-of-pocket payments although the government forgoes potential revenues. Several countries have felt compelled to offer tax holidays to businesses for reasons that are not borne out by the evidence:

- Tax holidays are viewed as compensating for a poor business environment.

Perversely however, and particularly in poor countries, tax holidays worsen the business environment not only because the government forgoes revenue from the individual investors granted the incentive but also because tax holidays result in reduced tax payment compliance from other taxpayers (who resent what for them is an uneven playing field). The revenues lost could be used to invest in infrastructure and thereby improve the business environment for all investors. Further, tax holidays sustain otherwise unsustainable businesses – businesses that are viable only with tax

benefits could quickly become unviable with even small cyclical economic downturns, or with expiration of the tax holiday.

- Tax holidays are easier to administer than performance-based incentives.

Although it is generally believed that tax holidays require no administrative effort, the reality is that they are as administratively intensive as any other tax instrument. This is borne out by the case of India, where tax holiday provisions generate more litigation than any other feature of the tax code. Businesses taking the tax holiday benefit must continue to file tax returns, and these are reviewed just like any other tax return. The risk of transfer pricing posed by tax holidays results in businesses facing intrusive tax inspections and audits.

- The need to be competitive.

It is true that businesses that export will be at a disadvantage in the international market, to those that operate in cheaper jurisdictions. To remain competitive, businesses would have to accept lower margins if they chose to remain in a tax-disadvantaged area. This argument, however, is valid only when all things are equal. Tax is only one of several factors, such as the costs of labor and raw materials, that affect businesses' balance sheets. All else remaining the same, a tax holiday might tip the balance in attracting certain investment, such as in export industries that are highly price sensitive. However, because tax holidays are of limited duration, investors that focus on negotiating tax holidays tend to be mobile and are likely to relocate to other low-tax jurisdictions once the holiday expires.

It is clear from IC research that the shortcomings of tax holidays usually outweigh any benefits they produce. In addition to the uncertainty of the benefits listed above, tax holidays have negative

consequences, some of which are the following:

- Firms have an incentive to close down and sell their business at the end of the tax holiday, only to reopen as a “new” investment, thus gaining an indefinite tax holiday. Tax holidays provide no incentive for growth and compare unfavorably to investment-linked incentives.
- With most foreign investors operating under double taxation agreements, tax holidays (in the absence of tax sparing) simply lead to a transfer of tax revenues from the country receiving the investments to the home country.
- Tax holidays threaten the existing tax base by allowing firms to funnel profits, via transfer pricing, from an existing profitable company through the “tax holiday” company and therefore avoid paying taxes on either.
- Most capital-intensive investments do not yield a profit for the first several years of operation so tax holidays for a “start-up” period of, for instance, five years are ineffective. In fact, in such cases tax liabilities kick in just about when businesses start to make a profit.

Box 33 presents the results of a tax holiday that India offered to an undeveloped state.

Performance-Based Incentives (IC 2009a)

Incentives such as investment allowances, investment tax credits, and accelerated depreciation are able to, depending on the size of the investment, reduce taxable income. They help businesses by moving the tax liability to later years and thereby reduce the present value of taxes paid. As a result, the cost-benefit ratio (in terms of additional investment generated per unit of revenue lost) is high. Such incentives specifically target capital investment and are superior instruments.

Box 33. Holidays in India... Tax Holidays, That Is

In India, there is no evidence that tax holidays for the industrially undeveloped areas, such as the northeast of the country, have resulted in additional investments in those regions. In fact, it has been found that tax holidays for investment in industrially backward states such as Himachal Pradesh have only resulted in shifting of investments that otherwise would have gone to the neighboring state of Punjab. Overall therefore, India has not benefited. Further, the investments in Himachal Pradesh have not been made in the industrially backward hilly regions of the state, but rather in those areas that did not face any disadvantage for investments.

Source: IC research, IC (2009a)

Export-Based Incentives (IC 2009a)

Export-oriented businesses are especially price-sensitive and any reduction in the cost of doing business, (including in paying taxes), can be passed on to customers in the form of lower prices, making the exporter more competitive in the international market. This makes export-based incentives one of the most effective types of fiscal incentives. However, tax is only one of several business costs and it is not clear that lower taxes by themselves affect investment. Nor is it clear, for the country as a whole, that the benefits of the investment compensate for the forgone tax revenue. All else being equal, export-based incentives are effective in attracting mobile investments such as in textiles, but these investments have limited backward linkages to the local economy and are usually quick to leave when the tax break is withdrawn.

Box 34. Country Examples on the Efficacy of Tax Incentives

Several countries have stopped giving tax holidays and replaced them with a uniform regime of low tax rates and highly selective and limited tax incentives. South Africa replaced its tax holidays with duty-free imports, higher capital allowances, zero-rating of VAT for exports, and so forth. In 1997, Uganda replaced its tax holidays with a lower uniform corporate tax rate and still attracted large increases in foreign investment. In 1984, Indonesia lowered the corporate tax rate from 45 percent to 35 percent and removed all selective tax incentives such as tax holidays, preferential tax rates, and accelerated depreciation. Despite this, FDI went up many times over the following decade. More recently, in 2005, Egypt replaced all tax incentives with a lower, uniform tax rate on profits, 20 percent. In the following year, tax revenues actually increased from 4 percent to 7 percent of the gross domestic product (GDP)

Tax incentives have worked but only when the investment climate was favorable and the broader macroeconomy provided a catalyst. Starting in 1959, Ireland provided tax incentives that included tax holidays and tax-free export profits. This did little for investment growth until 1981, when the tax holiday was replaced by a uniform but very low tax rate of 10 percent and combined with major reforms such as a tight monetary and fiscal policy. In Costa Rica, export promotion programs that included export processing zones (EPZs) and investment incentives failed to benefit the country until the mid-1980s when exports rose rapidly as the country's economy was stabilized, the currency was devalued, and the EPZ laws that were highly bureaucratic were relaxed.

Source: IC (2009a)

Regional/Subnational Incentives (IC 2009a)

To promote investment in deprived regions, many developing countries provide for a lower income-tax rate in distinct geographic areas but

some investors are quick to take advantage of, or to try to “game” such schemes. Investors may, for example, register a company in a disadvantaged area (to take advantage of tax incentives) but undertake the majority of operations in a high-income area.

Regional/subnational development is likely to be better achieved by addressing the investment-limiting factors in the region itself, for example, by improving infrastructure, lowering administrative barriers, and simplifying investment regulations.

Conclusions on the Effectiveness of Fiscal Incentives (IC 2009a)

Tax incentives, like any other market intervention, are justified if they correct market inefficiencies or generate positive externalities. In spite of very limited evidence that tax concessions work, their continued use is strongly driven by political economy reasons. Their appeal to politicians is considerable because discretionary tax incentives, especially in developing countries, allow political influence over policy options, provide the political gesture of action, and facilitate

Box 35. Conclusions on the Effectiveness of Fiscal Incentives in Several Jurisdictions

- Tax incentives have worked under limited sets of circumstances and only under a climate that is conducive to investment (improved infrastructure, pervasive rule of law, strong institutions, and so forth).
- When the investment climate is not conducive, tax incentives do not attract significant amount of additional investment; rather, they subsidize investments that were expected to come in any case and result in loss of revenue.
- When the investment climate is conducive, tax incentives reduce the cost of investment for business.
- Businesses that are attracted primarily because of tax incentives are those that operate on the margin. In the absence of the tax incentive, they are unlikely to be profitable. Such investments create little benefit for the country.
- Tax incentives are effective when there is tax competition between neighboring countries with a similar investment climate. However, an incentive regime that focuses on a country being able to compete against incentive-granting neighbors accelerates “a race to the bottom” that is ultimately harmful to both countries.
- Tax incentives are recommended for investments that have positive spillover on the economy such as those in infrastructure, research and development, health, and education.
- Some sectors, such as mining and tourism, that depend on natural resources within the country do not require tax incentives because the resources — a precious metal, a sandy beach, and so forth — are not readily available elsewhere. In such cases, tax incentives subsidize the investment.
- The best policy for investment is to have a low tax rate with a broad base (no exemptions or tax incentives).
- There is limited evidence that tax concessions work, but their appeal to politicians is considerable because discretionary tax incentives, especially in developing countries, allow political influence over policy options, provide the political gesture of action in the nature of a “dole,” and facilitate political and administrative corruption.
- Even if a tax incentive is successful in attracting investment, it is not without cost, which in some cases is more than the benefit. Malaysia, which has used tax holidays and EPZs with zero import duties and subsidized infrastructure since 1958, did attract large amounts of investments. However, the World Investment Report 2002 (UNCTAD 2002) mentions that the forgone revenue was as high as 1.7 percent of GDP and that some of the incentives were overly generous.

Source: IC research

Box 36. Country Examples of Tax and Corruption

In the Republic of Yemen, while the corporate income tax headline rate is 35 percent, the incentive regime reduces the average effective rate to 15–20 percent. Corruption also reduces the tax burden. Although paying a bribe costs between 25 and 40 percent of the assessed tax amount, it can lower the tax assessment by 50 percent, so that even many large firms file their informally negotiated tax amount under the presumptive regime.²³ In contrast, in East Asia, governments that offered nondiscretionary incentives were successful in attracting private investors, promoting exports, and achieving technological adaptation and innovation.²⁴

Countries like South Africa, Mauritius, and Botswana that have relatively low levels of corruption are able to attract high rates of FDI. According to the Transparency International index, highly corrupt countries – for example, Nigeria – also attract large amounts of FDI because of the influence of other factors like market size, growth, and natural resources. As Bowles has noted: “In many cases, political corruption is, at least, as serious an issue as corruption of the tax bureaucracy. Low salaries for tax officials, political protection of prominent tax evaders, poor monitoring of junior officials, high tax rates, high levels of discretion for the tax officials, and poor information generally are some of the reasons given for the persistence of extensive corruption in many countries in Africa, Asia, and Latin America.”²⁵ For example, a Transparency International study of 21 cities in Indonesia in 2004, found that the prevalence of corrupt behavior, such as tax officials helping taxpayers’ fraudulent practices, had an impact on tax revenue collected by the state. In Uganda, efforts to stamp out corruption have had limited effect. Fjeldstad et al. (2003) traced the prevalence of corruption at the managerial level in the Uganda Revenue Authority (URA) to politics. Although asset declaration was introduced in 2002 for all URA staff, the lack of political will to implement anticorruption measures effectively has produced only limited results, and when the URA Commission of Inquiry of Corruption, appointed in the same year, produced a much-delayed and debated report two years later, its legality was questioned by members of parliament and ultimately nullified by the high court. The URA offers well-paid jobs, relatively good working conditions, and rent-seeking opportunities, making it an attractive target of political interference in the recruitment, dismissal, and operations of the institution. Political interference, featured in the local media, further undermined the reputation of the URA. In 2003, for example, five senior officers attached to large taxpayer units (LTUs) were involved in a major corruption scandal.²⁶ Traditional networks of kinships or community origin also appear to be prevalent and tolerated within the URA. Strong political determination as well as broad policy and administrative reforms are needed to tackle the many corrupt practices including those around tax incentives.²⁷

Source: UNCTAD (2002), IC research, Bolnick (2004)

political and administrative corruption. Further, tax expenditures (incentives, concessions, holidays, exemptions) are especially politically attractive because the cost is usually unknown, because they invoke limited interference from “veto players” like legislatures, and because the loss to revenues is dispersed over the long-term, whereas the political benefits, especially of discretionary regimes, are immediate and offer opportunities for corruption.

Box 35 below highlights some conclusions drawn about tax incentives from IC extensive multi-country study and Box 36 gives some country examples.

Potential negative consequences from tax incentives include erosion of the tax base (tax revenue from investments that would have taken place even without tax incentives is lost), reduced efficiency, and increased welfare costs (tax burden is shifted to immobile tax bases such as labor). These undermine the tax system by increasing the tax burden on nonqualifying activities and encouraging rent-seeking activities.

²³ IC study April 2007

²⁴ Choi and Kwack (1990).

²⁵ Bowles (1998)

²⁶ See Fjeldstad and others (2003) on Tanzania.

²⁷ See Stotsky and WoldeMariam (2002) for Central America; Stotsky and WoldeMariam (1997) for Sub-Saharan Africa

Ironically, incentives mean little to substantive foreign investors, most of whom who are taxed on their worldwide income and are allowed a credit for foreign income tax paid so that their aggregate tax liability remains unchanged. For such investors, tax incentives, offered by countries that can least afford it, are means by which poor countries subsidize developed ones. “Hence, policies to enhance macroeconomic stability, transparency, other elements of good governance, openness to trade, infrastructure and the levels of know-how in the domestic economy are all more potent tools for attracting investors. FDI incentives may, at best, tip the balance in favor of one location among a group of economies that are perceived to have broadly equivalent enabling environments.” (OECD 2003)

Box 37. Tax Incentives and Investment in the UEMOA–CEMAC Country

The CFA Franc Zone consists of the eight WAEMU (West African Economic and Monetary Union) countries and the six CEMAC (Communauté Economique et Monétaire de l’Afrique Centrale) countries. Because these countries are relatively homogenous – they share a currency, speak the same language (French), and are in geographical proximity – they constitute a unique basis of comparison of investment and policies. In a study that investigates whether changes in the fiscal investment climate in these countries between 1994 and 2006 were effective in attracting FDI, the authors found that tax incentives had no discernible effect on the investment. Only a simplification of the tax incentives code (a reduction in the number of different incentives regimes) and the granting of more legal guarantees to foreign investors had a significantly positive impact on FDI. Investors highly value transparency, predictability, and enforceability of the tax system. The other changes including tax incentives, did not seem to be beneficial, possibly due to the weak quality of their investment climate.

Source: James and Van Parys (2009)

Good Practice Principles (IC 2009a)

Any policy decision by a government to use financial and other incentives to attract foreign investment should ideally be supported by prudent policy measures that create a sound investment environment, for domestic and foreign investors alike.

Principles that have developed from good practice standards that guide the design and implementation of investment incentives may be summarily presented as follows:

- All investors should be treated **equally**, regardless of nationality. Good investment policy and legislation should not discriminate between foreign and domestic investors. Differentiating between domestic and foreign investors by granting incentives distorts the business environment and creates an uneven playing field.
- As a good legal and implementation practice, any incentive should be provided for in the relevant **substantive legislation** (tax incentives in the tax law, customs incentives in the customs law, and so forth) and not in the investment code. However, and in spite of advice from the WBG and IMF, many investment codes include an incentives section that offers new fiscal rebates for foreign investors in particular. It is difficult to convince a country not to include incentives in the code when its competitors are doing so. If a country decides therefore to address investment incentives in its investment code, it should be persuaded to (i) reference the investment incentives in the investment code but to have the actual grant of the incentives in the substantive laws or (ii) include investment incentives in both the investment code and the substantive laws. Because of the transience of incentives, many governments are beginning to recognize the merit of such a recommendation.

- Incentives should be provided only **by law**, through an act of parliament. This helps to improve transparency in the award of incentives and enables the relevant authorities to administer them. In limited not recommended cases, where there is a need to design a specific agreement for investment that includes tax incentives, parliament should approve the agreement and the substantive laws should reflect its relevant provisions.
- For reasons of **transparency**, the granting of an investment incentive should follow a set of predetermined and uniform criteria to which the public is privy. Information on the actual incentive granted should also be available from the state agency that administers the related regulations and laws and from the relevant investment authority.
- Investment incentives should be **clear and targeted**. The investment incentives should be applicable in specific areas that government identifies for incentivized economic growth. The government should however undertake research to confirm that the targeted areas will benefit the country in ways that would not have happened in the absence of incentives.
- Investment incentives should be **regularly reviewed** to ensure relevance and effectiveness. It is necessary therefore that government develop a mechanism that submits incentive-based investment attraction strategies to periodic evaluation for their appropriateness and economic benefits against their budgetary and other costs, including long-term impact on resource allocation.
- Incentives should be administered by the governmental agency that has the administrative capacity to ensure compliance (for example, the tax authority or the customs authority) and not by the country's IPI. For example, the customs authority should administer incentives for the importation of raw materials or machinery. In addition, incentives should be **administered expeditiously**. The structure and administration of the investment incentives should be easily understandable and not require a complex administration. This ensures quick turnaround times for investors, because prompt decision-making is essential to attract and retain investment.
- Investment codes should not guarantee the stability of the tax system as an additional "incentive." It is not advisable for a government to legislate that income tax will not be increased, or to promise that they are likely to be decreased, for two reasons: (i) it may be a case of abdication of macroeconomic policy, and (ii) it raises questions of credibility of the authorities within the investor community.
- Incentives should be granted only after taking into consideration their revenue cost, that is, their **affordability**. The introduction of an incentive should not be a net cost to the government and the income forgone should not have a severe effect on its revenue streams. The introduction of an incentive should also not jeopardize financial allocations from the government to the agencies that administer such incentives. The determination of what is affordable would necessarily require coordination by agencies of government responsible for revenue collection and fiscal policy.
- Incentives should justify their cost and should be granted in a way that allows maximization of the intended outcomes with minimum loss. When stimulating certain economic activities or sectors (such as agribusiness) or when establishing a policy to attract investment, government should avoid

Box 38. List of Examples illustrating that direct spending is more productive than tax concessions

Evidence confirms that direct spending is more productive than tax concessions to an individual investor.

- Example 1, tourism: In a country with very poor road infrastructure, one dollar spent on road infrastructure to a touristic area can create more economic activity than one dollar of tax concession to a tourism firm.
- Example 2, manufacturing: In a country with poor infrastructure and low-skilled labor, one dollar spent on road or port infrastructure/ telecom/ education would attract more companies than one dollar of tax concessions to a manufacturing firm.

If a government decides to grant tax concessions, it should only do it for one of the following economic reasons:

1. **Stimulate investments or economic activity that has positive spillovers to the rest of the economy:**
 - Good example 1: The market does not reward the fact that when a firm invests in R&D, this also has a positive impact on other firms because of learning and technology spillovers. Therefore incentives for R&D are defensible.
 - Good example 2: The market does not reward the fact that when a firm invests in environmentally sound production processes, this has a positive impact on the health of the entire population because of reduced pollution of air and waterways. Stimulating environmentally sound production is a good incentive.
2. **International tax competition:** Incentives are only good if they attract investments that would otherwise not have taken place in one country but in another country with a similar investment climate. As a result, incentives should focus only on economic activity that is mobile and as such looking for the country with the highest ratio of public goods and services over tax payments. A company is only mobile if it can export what it produces and if it is not dependent on local resources for its production. As a result, tax incentives for the reason of international competition should focus on exports, and not on the production for the domestic market.
 - “Good example”: An international textile company that wants to provide the world with clothes is looking for the country with the best investment location from which to export its goods. One element of the investment climate could be tax concessions only for the exports of the company.
 - “Bad example”: Mining companies are not mobile because they need the natural resources that exist only in a given country. Even though they export their product, they should not be given exemptions because they need to be in that country to do the mining.

Source: IC (2009a)

waste and always ask what policy decision is likely to generate the most economic activity or growth in the long run: spending a dollar directly on infrastructure/public services or spending a dollar through tax expenditure. The answer depends on the level of public goods and services that is already present in the country. The less-good the infrastructure and public services in a country, the higher the productivity of one dollar spent directly on infrastructure or services as compared

with the productivity of one dollar spent on tax concessions. Further, a dollar spent as a tax concession benefits only one investor, while a dollar spent directly on infrastructure benefits multiple investors.

- The practice of granting incentives on a case-by-case basis might be discriminatory and certainly will create opportunities for corruption. Incentives should be granted automatically and applicable to all depending on their

satisfying certain conditions prescribed by law.

- Governments should take into account treaties signed when granting investment incentives.
- All investors benefiting from tax incentives should be required to file tax returns on due dates in order to be able to claim tax exemption (IC 2009a).
- The tax authority needs to audit tax concessions to prevent leakage. This requires building adequate auditing capacity. In case of capacity constraints within the tax authority, there should be a requirement for filing an audit report certified by a qualified auditor verifying various conditions for the tax exemptions.

- The government should prepare a budget that includes the cost of the tax incentives and provide this to parliament in the annual budget.

There are clear research findings to support the proposition that investment decisions founded solely on incentives are likely to be counter-productive to the offering country, because such investments tend to be short term and make little contribution to sustainable development (Mintz 2008). Governments have a sovereign right to do what they believe to be in the interests of their countries and tax incentives, like any other market intervention, are justified if they correct market inefficiencies or generate positive externalities. Investment incentives rarely achieve the ends for which they are given and governments need to consider the costs against the benefits of any incentive.

CHAPTER 7: INVESTMENT PROMOTION INTERMEDIARIES AND INVESTMENT LEGISLATION

Investment promotion is generally aimed at attracting FDI.

An IPI is the institutionalization of a government's policy for FDI promotion and the creation of an IPI can send a signal to foreign investors that the country is open for investment. Effective IPIs play a crucial role in attracting and facilitating FDI – the quality of services that the IPI provides to an investor throughout the investment project cycle may determine if the country secures the investment, and may lead to re-investment down the road.²⁸

IPIs are often created within a country's investment code. This section seeks to provide answers to the following questions:

- Which IPI provisions should be included in the investment code?

- What is the role of an IPI?
- What is the status and structure of an IPI?

Which IPI Provisions Should the Investment Code Include?

If a country wishes to create an IPI, it is advisable, for establishing its legitimacy and supremacy, to do so by legal measure, rather than by ministerial decree. Although there is no best practice on how this should be done (placed in the investment code or in a separate law), it is recommended that the constitutive statute of an IPI be in a separate law. There are two arguments in favor of this, (i) it keeps the investment law concise, (ii) investment laws increasingly cover both domestic and foreign investment whereas IPIs focus mainly on attracting FDI, and (iii) it gives the government the flexibility to adjust the institutional structures without having to revise

²⁸ About 92 percent of companies and their site location consultants contact IPIs to seek information during the site selection process (and thereby lower their transaction costs). (IC 2009b) <http://www.globalinvestmentpromotion.com>

the investment law. In addition, when IPI creation is part of the investment code, IPIs are frequently assigned the role of “guardian of the code,” which makes them responsible for its application in the facilitation and approval of investment incentives, foreign investor approvals, and performance monitoring. This series of regulatory tasks should be avoided as they usually dilute the business and marketing orientation of an effective IPI.

However, if the set-up of the IPI is provided for in the investment code, it should, at a maximum, concisely address (i) IPI creation, (ii) basic mandate and objectives, (iii) governance, (iv) funding, and (v) reporting lines. While the code will reference the law on public agencies/authorities (or other administrative statutes), it should permit the flexibility that will enable the IPI to evolve in accordance with its corporate plan and organizational needs.

Role of the IPI

As introduced above, an important issue to consider in demarcating the role of an IPI is whether it should have regulatory or only promotion functions:

Regulatory function, means getting involved in investor screening, administrative approvals, and the award and supervision of the use of incentives.

Promotion is the marketing of the country as an FDI destination to a business audience. This includes the facilitation of foreign investors through the investment process, the provision of aftercare services, and involvement in policy advocacy (investor feedback) for improving the investment climate, as the most basic activities for the IPI.

International experience shows that some IPIs perform both functions, while others do promotion only, with regulatory functions the purview of relevant line ministries and other governmental agencies. IC research suggests that IPIs that do promotion exclusively tend to be more successful in winning FDI projects (Box 39). Their role is clear and transparent to investors: promote, facilitate, and advise the government on investment policy. (Box 40 provides a more comprehensive list of promotion duties, and Box 41 contains illustrative IPI mission statements from selected countries.)

Often IPIs are in difficult investment climates and try to win investment projects by awarding individual investors incentives administered and monitored by the IPI, which is not recommended. A regime for evaluation, approvals, and licensing of investments may create opportunity for the IPI to interfere in the affairs of the investor, enhance opportunities for

Box 39. Why Not Assign Regulatory Functions to an IPI ?

- Performance: None of the top-20 performing IPIs in the 2009 Global Investment Promotion Benchmarking report (IC 2009b) has regulatory responsibilities. In contrast, all bottom-20 performers do.
- Mindset and recruitment: Regulation is typically a function of government, whereas promotion and marketing are oriented toward private sector business. The two activities need different skills, experience, and enabling environment.
- Conflict of interest: Regulation and promotion are different and sometimes contradictory: Investors may see regulation as a constraint, while promotion aims at encouraging investment.
- Priority is often given to the administrative task over the promotional activities.

rent-seeking behavior, and set the stage for potential distortions of the market. Evidence shows that there is no alternative to reforming the investment climate and that IPIs that both promote and regulate investment often fail to deliver on their promises.

If a country does decide to assign its IPI both regulatory and promotion functions, it is important to place the two functions in separate departments with clearly delineated mandates, and to adopt a legal status (such as a parastatal organization), human resource strategy, and employment and salary policy that provide the ability to attract and retain qualified staff. Governments should be aware that with the

Box 40. Example of Key Functions of an IPI

1. Promote and improve the image of a country or region as an investment location
2. Advocate improvements in the investment climate to increase the competitiveness of the country as an investment location
3. Develop and implement, in collaboration with relevant private sector partners in the country, an investment promotion strategy
4. Research and publish investment opportunities
5. Identify and seek out potential investors
6. Facilitate entry of new investments
7. Provide services, to established investors to promote investment retention, investment expansion, and the maximizing of development benefits to the local economy

Source: <http://www.wbginvestmentclimate.org/advisory-services/investment-generation/>

traditional civil service recruitment and pay policies, it would be difficult to recruit qualified and specialized staff such as staff with marketing skills.

Box 41. Good Examples of IPI Mandates

Following are mission statements from country IPI Web sites:

Austria: "ABA-Invest in Austria the national investment promotion company, is the first point of contact for foreign companies aiming to establish their own business in Austria. We are owned and operated by the Republic of Austria, and report directly to the Austrian Ministry of Economy, Family and Youth.

The services provided by ABA-Invest in Austria are free of charge. We provide professional consulting services to firms interested in setting up business operations in Austria, focusing on all issues relevant to selecting an appropriate location. In addition, we provide detailed information about Austria as a business location, and proactively approach potential investors."

<http://www.aba.gv.at>

France: "From the moment you contact one of our offices, whether in France or abroad, and even after your project is up and running, you can count on the IFA [Invest in France Agency] to offer tailored expertise every step of the way:

Our experts can give you detailed information on the legal regulations that apply to your investment. We also draw on the support of French businesses that belong to the IFA Partners Network, which includes banks, financial institutions as well as accounting and auditing firms that are able to provide specialized services." <http://www.invest-in-france.org>

Turkey: "The Republic of Turkey Prime Ministry Investment Support and Promotion Agency (ISPAT) is the official organization for promoting Turkey's investment opportunities to the global business community and rendering assistance to investors before, during and after their entry into Turkey.

ISPAT serves as a reference point for international investors and as a point of contact for all institutions engaged in promoting and attracting investments at national, regional and local levels."

<http://www.invest.gov.tr/en-US/theagency>

One-stop Shops

Responding to foreign investors' complaints about administrative obstacles and the regulatory climate generally, and the number and complexity of required investment approvals in particular, some governments have established so-called "One-Stop Shops." The OSS gives investors a single-window entity from which to obtain all necessary paperwork and approvals for company set-up in one streamlined and coordinated process. That is, OSSs essentially coordinate government regulatory functions as they pertain to investment. Because IPIs tend to be the entry point for foreign investors, OSS have often been set up on IPI premises or even under IPI supervision. However, this latter arrangement – promotion and regulation residing in the same organization – is rarely advisable, because there is potential for conflict of interest and it may be viewed with suspicion by investors. It is wiser to separate the OSS from the IPI and to establish a good working relationship between the two organizations so that the IPI's facilitation leads seamlessly to investors' accessing OSS.

Box 42. Challenges Faced by OSSs

1. The OSS becomes just one more layer of bureaucracy, a "one-more stop shop."
2. The OSS becomes a "mail box."
3. Existing authorities are reluctant to delegate approving powers with the OSS.
4. The OSS weakens government controls and policy objectives.
5. There is no "one size fits all."

Source: IC research

More generally, experience shows that when a country's investment bureaucracy remains complicated, most OSSs fail to serve investors,

and become "One-More-Stop Shops." Governments would do better to simply streamline their administrative and regulatory processes and procedures for investment. A streamlined system would give an OSS greater chance to successfully serve investors.

An example of keeping the IPIs and the OSS separate is the Key Account Executive model, used by successful IPIs such as Ireland and Singapore. In this model, the IPI appoints a dedicated account executive to each investment project. The account executive helps the investor with procedural and other investment start-up issues, including making visits to the various relevant agencies, collecting relevant forms, and following up on information requests. Additional information on OSSs can be found in the IC 2010 Handbook "How Many Stops in a One-Stop-Shop? A Review of Recent Development in Business Registration."

Status and Structure of IPIs

The effectiveness of an IPI depends to a great extent on its mandate, independence and stature vis-à-vis its government. According to research undertaken by UNCTAD, certain institutional characteristics of an IPI are associated with better performance and delivery (OSCE 2006). Although about 80 percent of the IPIs surveyed were government agencies, it was clear that the application of civil service processes to the operations of such agencies was not optimal because IPIs have responsibilities and functions that differ from other government agencies. In general, independent agencies tend to perform better with the investment promotion function. This was also confirmed by the findings of the Global Investment Promotion Benchmarking (IC 2009b), (Ortega and Griffin 2009).

In determining the right structure for a country's IPI, the key consideration is what type of organization is likely to work best within existing government structures. The answer varies for each country, depending on the political climate, the government's institutional framework, and the civil service culture. Box 43 presents the most common structures for investment promotion, with advantages and disadvantages of each.²⁹

To execute their work efficiently, IPIs should be a legal entity with a high degree of operational independence and reporting to the highest level possible of government. The IPI should be a legal entity with the right to sue and be sued, the right to possess and dispose of any movable or immovable property, and the right to enter into contracts. However, should IPIs be public or private entities?

Most IPIs are purely public bodies. Being a public body is important for the image-building and advocacy function. A survey that surveyed 98 IPIs worldwide shows that successful IPIs are most typically given focused mandates but are allowed to pursue them with minimal interference. "Although 73 percent of top IPIs are purely public bodies, only about three in ten of these are ministerial subunits" (IC 2009b), (Ortega and Griffin 2009, 3); the others are autonomous, positioned outside ministries, and reporting directly only to a minister or higher authority. Nearly half of the weak IPIs are subunits of ministries. Based on the above, it is recommended (i) not to have the IPI as a subunit of a ministry and (ii) to give the IPI autonomous operating authority. It is also important to add that high-level reporting (to the Minister of Finance, Office of the President, and so forth) are essential for the effectiveness of the IPI especially for advocacy purposes in countries where business climates may be the key obstacle to investment.

²⁹ <http://www.wbginvestmentclimate.org/advisory-services/investment-generation/> and the investment promotion toolkit at <http://www.fdipromotion.com>

Governance is a crucial issue for an IPI. Generally, only relatively autonomous IPIs have a board of directors. Non-autonomous IPIs have an advisory board with the same functions as the board of directors but without legal authority over the operations of the IPI.

It is essential for the board, to have a strong representation from the domestic and foreign private sector (that is, investors and professional advisors). The expertise of the private sector is crucial. However, conflicts of interest, bias, confidentiality, and business proprietary rights issues might arise because of the private sector representation (Ortega and Griffin 2009, 2), such as board members being competitors or suppliers of a particular investor, or an investment project competing with the interests of a board member. Therefore, it is important to set clear rules for the governing board members' use of commercially sensitive information provided by investors, thereby avoiding conflicts of interest situations by having good governance (voting exclusions, attendance exclusions, limiting appointment renewals, and so forth).

Checklist – Financial Provisions

With respect to its financial provisions, the IPI should have:

- Independent financial accountability
- An annual budget governed by executive regulations
- The same financial year as the government ministries
- Its funds considered public ones and not being able to be re-possessioned by prescription
- A clear financing mechanism

Box 43. Summary Comparison of IPI Institutional Set-Up

Advantages

Integral Unit of a Major Ministry (Finance, Trade and Industry, Planning/Economic Development)

- The IPI's status within the government is clear to other parts of the government.
- The IPI is well placed to influence the ministry's internal policies that are relevant to investment attraction. Issues can be resolved in house, thereby avoiding discussions between agencies of government that may have competing agendas and objectives.
- Investment promotion is more likely to be viewed as a priority by the minister. Because the newly established IPI has been added to the ministry's portfolio, the minister can feel a strong sense of ownership of investment-related issues.

Disadvantages

- A ministerial office is unlikely to be well suited to the self-starting, business-oriented style common to most successful IPIs.
- Civil service procedures are often slow and cumbersome. An IPI needs financial autonomy to allocate its budget without approval of each decision by a central financial body. For example, the chief executive should be able to schedule an overseas visit by an employee without referring to other individuals in the ministry or civil service.
- It may be more difficult to recruit executives with private sector experience to work in a public sector institution. Most successful agencies worldwide have a mix of talented individuals from the public and private sectors.
- The IPI may not have enough authority to influence decisions, behaviors, reforms, etc. under other ministries and government agencies, all likely to be at the same administrative level of the IPI or its home ministry.

Unit within the Prime Minister's or President's Office

- Association with the prime minister or president's office increases the status and potential influence of the IPI.
- Because the IPI is not associated with the agenda of any one ministry, it is better able to argue the case for change with ministries whose policies or regulations discourage investment. Other ministries are less likely to feel that the agency is following a competing ministry's agenda.
- Foreign investors tend to like the idea that the IPI is at the center of government, because it signals that foreign investment is a high priority of the government.
- The IPI probably can be set up without the need for special legislation.
- There is a danger that too many routine decisions will be referred upward to busy members of the prime minister or president's immediate circle of advisors. As a result, these decisions may be delayed. Furthermore, this may also undermine the sense that operational decisions are the responsibility of IPI staff.
- The IPI may be constrained by civil service procedures that can be slow and cumbersome. An IPI needs the financial autonomy to allocate its budget without approval by a central financial body.
- It may be difficult to recruit executives with private sector experience to work in a public sector institution, and most successful agencies have a mix of talented individuals from the public and private sectors.
- It may be difficult to avoid having negotiations on large projects be unduly influenced by short-term political considerations, rather than by economic and commercial criteria. This can result in pressure to grant overly generous concessions.

Box 43. Summary Comparison of IPI Institutional Set-Up (continued)

Advantages

- The IPI has an individual identity with its own budget. It is also seen as an integral part of the government in its own right, rather than as an adjunct of another ministry.
- The IPI has its own minister to argue its case within the government.
- The IPI can take up the case of individual investors without influence from other agendas that might constrain it if it were a unit within a larger ministry

Disadvantages

Separate Ministry

- The agency will typically be a small ministry in terms of its portfolio and budget, and may consequently be headed by an individual minister with limited status.
- The agency may still operate under civil service procedures. As a result, it will lack the financial autonomy it needs to allocate its budget without approval by a central financial body.
- The IPI's public sector status is likely to make it difficult to recruit executives with private sector experience.
- This structure may make the IPI more sensitive to short-term political considerations. This may affect its negotiating position with large potential investors. Thus, the agency may focus more on the short-term political gains from "landing" a large project, rather than on the project's longer-term economic and commercial impact. As a result, overly generous concessions may be offered to a foreign investor

Fully Autonomous Agency

- The IPI has a distinct identity, its own budget, and its own chief executive officer and board.
- The IPI can be run with more flexible procedures than can a government department; it can hire staff from both the public and private sectors; and it can authorize needed expenditures.
- The IPI is better able to lobby publicly for necessary changes in the business environment than it could if it were embedded in a government department.
- As a separate, accountable body, the IPI's performance is likely to be more open to parliamentary and public scrutiny. This model has been used by many of the most successful established IPIs (for example, Scotland Development International, Irish Development Agency).
- It should be possible to persuade talented private sector leaders to serve on a board of directors and to recruit private sector staff on contract rather than on civil service terms.
- This model may not work well under governments unfamiliar or inexperienced with the concept of an autonomous agency. In such a case, an autonomous IPI may be marginalized and not have the same influence over government policies, as would an IPI located within a ministry.

CHAPTER 8: PROJECT CYCLE FOR INVESTMENT LAW REFORM

As part of its effort to retain the strong demand-driven orientation in the delivery of advisory services, the WBG, through IC, has developed a framework for evaluating government requests for technical assistance in the area of investment climate reform. This handbook follows the framework – with modifications to accommodate an individual product. Please refer to Appendix 4 for an overview of the project cycle.

Upon receipt of a government's request for an investment policy and/or law reform, the team evaluates the request and determines the degree of engagement and may decide:

- Not to proceed with the project
- To proceed with a desk review and submit a report
- To substantively engage and develop a medium- to large-scale project. Such engagement will typically involve a pre-field research, a scoping mission, and the

preparation of a report with recommendations for reform. Should the government then request support for implementation of the report's recommendations, that support will take the form of developing an action plan for reform, developing a policy framework to reform the legislative text, and assisting in drafting the legislation and in steering the draft law through the enactment process.

Evaluating a Government's Request

Each intervention on investment law reform must start with a request for technical assistance from the government. Although these projects may sometimes be initiated by IFC or World Bank staff (country managers, country economists, Private Sector Development specialists, IFC investment or advisory officers etc.), who bring this service to the attention of their

counterparts in a beneficiary country government, the technical team must ensure that a formal request is received from the appropriate authority within the client government, confirming both the government's intent to reform the investment law or policy and the need for such assistance.

The technical team should evaluate the request by using available information such as that available from the Investing Across Borders, Doing Business, and the Investment Policy and Promotion questionnaires and analysis.

Looking at the Client

As a first step in reviewing a request for technical assistance for investment law reform, the technical team's assessment of its role and the resources required to deliver its expertise must be informed by a number of indicators, principal of which are the following:

- i. *The authority of the party requesting the technical support to make such a request.*

For reasons that will be clearer below, it is necessary to ensure that the government ministry or agency requesting technical support has the authority to make such a request and the political stature to see the reform through to the end.

Although it may be difficult to determine a priori which government entity has the clout to be a champion, the Office of the President/Prime Minister, Ministries of Finance, Ministries of Commerce, IPAs, and other specialized development agencies are the usual legitimate sources of such requests. It may be useful in some cases, however, to assemble a coalition of champions and get each to send a formal request that makes reference to other partners.

- ii. *The government's capacity to sustain the project.*

Whether or not the government has the requisite human and financial resources to undertake potentially controversial legislative reform should be a key factor in undertaking any investment policy and law reform project. Enacting legislation is one of the greatest manifestations of sovereignty, and the role of government in developing the legislative text as well as securing internal support for passage cannot be overstated.

- iii. *The government's commitment and political will for reform.*

The path to hell, it is said, is paved with good intentions. Although most governments, especially new ones, readily express an eagerness to undertake legislative reforms that empower the private sector, investment law reforms have typically proven politically difficult. A government's commitment to risk losing political support by engaging with stakeholders, who benefit from the status quo, is essential.

To determine whether or not such political will exists, the technical team would investigate the political history of the country, the stability of the political regime and government, the political traditions and commitment of top leadership (President/Prime Minister/Head of government) to reform, and the capacity of the top leadership and administrators. Also important is to seek an understanding of who the likely challengers will be and what will motivate them. This last inquiry will be important mainly to make a case for reform and assist the government in successful promulgation of the law.

- iv. *The history of the WBG with the country.*

Although due regard should be paid to changed circumstances and interlocutors, the

history of the WBG with a country should be one of the means to determine the existence or absence of such commitment, and the chances of success of the project.

v. *The potential for success.*

A careful review of the foregoing as well as an assessment of the Monitoring and Evaluation matrix in Chapter 10 yields a clear understanding of what success is.

The potential for success of an investment law reform project will depend also on other factors such as:

- Timing within the political cycle: new governments are generally more reformist than old regimes and few reforms occur in the final year of an election cycle
- Identification of professional, legislative, civil society, and private sector champions/challengers
- Design of a reform communications strategy that establishes local ownership of reform agenda
- A sequenced outreach campaign that networks the identified champions for effective evidence-based advocacy for reform

It must be noted here that unlike other Advisory Services projects where legislative reform is the means to an end (such as creating a business registry or a platform for alternative dispute resolution), the objective of an investment law reform project is the passage of a law that will ultimately lead to increased private investment in the economy. Success in this regard is therefore defined as promulgation of a progressive law – not as an intermediate step to achieving the project objective, but as the project objective itself.

(vi) *The existence of funds.*

An important factor to look at, at this stage, is the existence of the necessary funds to pursue the project.

Screening the Request

i. *Understanding the exact scope of the government request.*

It is important to understand the exact scope of the government request (that is, whether they seek technical support in reforming a policy framework, legislative text, or both). This permits the technical team to determine whether the reforms sought are necessary. It also permits the technical team to understand what expertise to deploy as well as the time and resources required to deliver on the government request.

It is quite common for a government to start by requesting a discrete activity (typically a desk review of a draft Law that the government agency has developed and wants to “vet” with the World Bank-IFC), only to realize later that significant additional support is required. If the scope of the engagement has not been adequately determined in the beginning, there are risks of the team being perceived as unresponsive to the government’s needs.

ii. *Assessing if request is aligned with the WBG strategy.*

Based on the understanding of the request, an assessment on whether the request falls under the WBG strategy for the country has to be done.

Please refer to Appendix 5, which provides a template to assist in the evaluation of the client’s request.

Screening of Existing Policies and Laws

The process of determining the degree of engagement by the technical team on investment policy and law reform requires a screening of the existing policies and laws to identify gaps – if any – in the legal regime for investment. There is not much point, for instance, in developing an investment law project if the Constitution of a country deprives investors of the right to claim compensation after expropriation of their assets, or otherwise actively does away with the kinds of protections that investors seek.

The Law Assessment Tool, presented in Appendix 6, can assist the technical team to make such an assessment.

Appendices 7, and 8 – drafting guidelines, and checklist of key issues to be included – can assist the technical team to make an assessment and later prepare their recommendations.

Determining Degrees of Engagement and Funding

Levels of engagement by the technical team on investment policy and law reform programs can vary from a discrete diagnostic assessment referred to as a desk review of legislative texts and policies, to medium and sustained interventions – usually as a part of a large-scale country program of the World Bank or IFC.

The level of intervention will depend on various prerequisites, mainly the country/client's request and capacity as well as available funds.

Although the WBG is widely perceived as having

“deep pockets,” the reality is that unplanned spending on the delivery of any advisory services is not possible. Ascertaining from the outset the availability of funds and how much is available is therefore an important prerequisite for any engagement on an investment law reform project. Possible sources for such funds are the World Bank country programs, IFC advisory services country programs, and even IMF country programs.

Elements of Small-scale Engagement

Desk reviews can be undertaken as discrete activities in response to specific requests from the country, the WBG, or the IFC, or as part of sustained activity (to inform the design of a comprehensive investment climate country program and so forth).

The desk review will involve the following three steps:

- Assessment of the investment laws and policies in the client country. This would entail a benchmarking of the country's current and recommended investment law regime against both global good practice and competing investment destinations.
- Preparation of a report adapted to reflect the political and social contexts of the client country. The report will typically also address the urgency, opportunity, relevance, and benefits of reform.
- Submission, presentation (if required) and discussion of the final report and recommendation with the client.

Elements of Medium- and Large-scale Engagements

Small or large engagements can also be undertaken in response to specific requests from a country, the WBG, or the IFC, or as part of a sustained activity (such as the design of a comprehensive investment climate country program).

Medium- and large-scale engagements involve a much deeper involvement that extends to field mission and to post-enactment assistance for large-scale engagements.

After evaluating a government's request and resolving to proceed with a medium- or large-scale engagement, the following steps will have to be undertaken:

- Pre-field research
- Field research (scoping mission)
- Delivery of a report and project plan

Appendix 9 will assist the technical team to make an assessment at this stage.

Pre-field and Field Research (Scoping Mission)

Pre-field and field research (scoping mission) are critical if the reform proposals to be presented to the government are to have any chance of success. The research should be focused on identifying stakeholders and understanding the political economy, which is critical to any legislative reform initiative.

Typically, the main stakeholders of investment policy and law reform are the government and its constituent agencies (some of which could suffer a loss of authority from reform), the domestic private sector, and international investors. In different countries, key constituencies in academia, the Diaspora, the legislature, professional associations, media and traditional authorities can, drive or retard progression of any reform agenda, including specifically investment policy and law reform. Box 44. details the key assessments necessary to understand the political economy.

Delivery of Report and Project Plan

Project initiation

The initial mission to a client country and the meetings with the government and the various stakeholders should deliver the following:

- Assessment of the investment laws and policies in the client country. This would also entail a benchmarking of the country's current and recommended investment law regime against both global good practice and competing investment destinations
- Preparation and presentation of a report adapted to reflect the political and social contexts of the client country and including the above-mentioned assessment and proposed amendments.

Box 44. Assessments to Understand the Political Economy

- *Assessing political will for reform*

An effective stakeholder mapping should identify the often competing interests within government and or the legislature. Understanding the political economy of the country helps to define a specific set of triggers/ issues that can either coalesce or fragment key constituents around the reform agenda.

- *Assessing intra-governmental relationships and interests*

Similarly, an effective stakeholder mapping exercise should help to identify other priorities – national development plans, ongoing or proposed development projects – successful attainment and conclusion of which would be greatly improved or retarded if the investment policy and law reform project were to take place.

- *Assessing private sector interest needs and capacity*

Many private sector associations in developing countries are constrained in a number of ways. These include improper articulation of their objectives, unclear mandates, lack of administrative competence and functional capacity to provide services to their members – including effective advocacy. Often therefore, there are competing private sector associations in a country, and understanding their expressed as well as core interests, motivation, support, and capacity is important in determining when, where, and how to engage and network them, including deciding who should be the first-generation champions or public advocates of the investment policy and law reform project.

- *Assessing institutional location and capacity of investment promotion*

Although most countries have a formal institution responsible for investment promotion, there are usually other centers of influence and power that can effectively support or retard reform that can lead to effective investment promotion. To develop a coalition of support within government, there should be input from, or at the very least appreciation of the benefits and relevance of investment policy and law reform by functionaries who are directly in charge of investment promotion.

Where the IPI is unlikely to be of much use in developing a progressive legal framework and investment-generation capacity, every effort should be made to build such capacity.

- *Assessing interests of development partners*

A mapping of development partners active in the country will help identify key private sector-related projects. Milestones for complementary projects can be built into the investment law reform strategy and presented to donors as reinforcement for their programs. Effective networking of development partners can also provide a firewall that prevents a particular donor from being singled out for negative treatment.

- *Identifying and building the capacity of champions in key constituencies, including academia, Diaspora, media, and professional associations*

Whether or not they benefit directly from the investment law reform project, depending on the political economy context of the country, there may be key constituencies beyond the traditional ones that can provide strategic support. An effective communications audit and stakeholder mapping exercise, undertaken preferably with a perception survey (to provide a baseline) as part of developing a reform communications strategy for all components of a country program, will help to identify the common links and points of diversion between such groups. It will also permit an assessment of their strengths and weaknesses and their capacity to advocate in support of reform in general.

- *Identifying and networking with key members of the legislature and other champions for reform*

There are often locations in a country – determined by geography, natural resources, industrialization, and population – that could benefit from other investment climate and private sector-led projects if the investment policy and law reform project is successful. National and local representatives and as well as residents of these locations should be identified in the stakeholder mapping.

Box 45. List of Important Activities in this Phase

- A comprehensive Communications Audit and Stakeholder Mapping with a perception survey to identify key issues/triggers and core messages that can help establishing local ownership and relevance of the investment policy and law reform project
- A cost/benefit analysis of the expected indirect impact of the recommended reform on key sectors of the economy
- Identification of and engagement with key professionals in the private sector, legislature, and civil society (frequently this requires the media and professional associations/academia) to provide relevant input and support the recommended reform
- Strategic engagement of the key media, identified through a communications audit
- Identifying and networking with key constituents in the public sector, specifically senior government officials and technical civil servants in the relevant ministries, and with the public to gain support for reform

Project planning

Should the government agree to proceed with the recommendations, the team will have to proceed as stated at the introduction of this chapter, with a planning phase that should yield an action plan for the development of investment policy, for revision of the legislative text, and for steering the new law through the enactment processes. Further details of the mechanics of project planning are provided in Chapter 9.



CHAPTER 9: SUPPORTING THE DRAFTING AND PROMULGATION OF THE LAW

When a new investment code needs to be drafted, or an existing code improved, the reform initiative will increase its chances of success by paying attention to two dimensions: making the case for change and building support for the reform. There is abundant literature on good practices in legal reform and drafting in the context of economic development.³⁰ The good practices include the adoption of a participatory methodology – consulting with stakeholders at critical stages in the process – and a clear strategy or clear investment policy that the code will help implement.

³⁰ See for instance Seidman, Seidman, and Abeysekere. (2001).

The drafting of the legislative text itself should start only after (i) an investment policy and strategy has been formulated, (ii) the various features of the code agreed upon, and (iii) the overall legal framework reviewed to identify possible gaps, overlaps, and possible conflicts with existing law.

The following sections provide information and advice about (i) resolving challenges commonly encountered in preparing an investment code; (ii) how to “make the case for reform,” and (iii) how to build support for reform through communications. The chapter then discusses drafting the code and post-enactment assistance.

Challenges in Preparing an Investment Code

Drafting any investment code presents at least two major challenges in addition to the implementation challenge:

- **Excessive complexity.** The topic of investment touches upon many different legal areas: property rights, business law, the law of contracts, administrative law, the judicial system, taxation law, health, labor, and environmental law, specific sectoral laws among others. This tempts policymakers and law drafters to develop an elaborate piece of legislation that likely will prove too ambitious and too detailed to enact or implement. They should resist such a temptation – investment code needs to be succinct, so investors can quickly read and easily understand it.
- **Systemic inconsistencies.** No legislation on investment will be wholly self-contained. Even implicitly, it will refer to other national legal provisions that, (especially where they are public policy rules), might conflict with and even override the investment law. In particular, administrative agencies and judicial institutions will have to interpret and implement the investment law in its legal context, and to deal with heterogeneous and inconsistent rules. To minimize inconsistency, investment legislation should not be conceived in isolation – a broad range of stakeholders, including government legislators, ministries, and administrative agencies as well as representative business associations and other interest groups – should be asked to review comment on it.
- **Deficient implementation.** If poorly implemented, the best legislation will not lead to success. In many developing countries, the private investment process still faces redun-

dant and cumbersome bureaucratic procedures. To overcome this, institution building – of efficient agencies that administer properly designed procedures – needs to complement the legislative process. In addition, agency staff should be qualified in investment promotion and technical fields, trained to communicate fluently with experts, and able to explain the intricacies of the country's business environment to both foreign and domestic investors.

Making the Case for Reform

Although investment law reform on its own is unlikely to directly address pressing needs, for example, to create formal employment, automatically increase investment, or address transparency and efficiency in government procedures, it can engender conflict. To avoid this, a strong case for reform should be developed from the onset. The core argument should then be distilled into compelling, nuanced messages for the different audiences that the anticipated reforms will help. In particular, these messages should demonstrate the advantages and benefits of investment reform for each audience.

In developing the messages, the technical team should answer the questions in Box 46.

Building Support for and Sustaining Reform through Communications

Using communication to build consensus for reform is a critically important and often overlooked activity. For example, in Liberia, where

Box 46. Advocating for Reform: A Questions Guide

1. What are the benefits and challenges of the current investment policies and laws and how do they affect the domestic private sector and international investors?

Develop clear core and audience-specific messaging supported by quantitative and qualitative data from within the country as well as other competing investment destinations that provide a compelling reason for reform. Play the “devil’s advocate” and identify arguments against these messages to improve the messages. Use these “factsheets” to both preempt and rebut challenges to reform.

Make sure that messages directly address the pervasive yet incorrect perception that investment law reform will benefit only international investors. Build awareness and knowledge about reform to ensure that investors, small or large, domestic and international, operate in a transparent, nondiscriminatory and progressive commercial environment.
2. How will an entrepreneur gain from reform – put a name, face, and voice to the reform?

Make the campaign relevant to the constituents who matter by supporting informed advocacy of credible entrepreneurs through key media outlets. Showing these entrepreneurs how their businesses and the economy will benefit from the proposed reform is priceless.
3. How will the economy and other stakeholders gain from reform?

Often countries that seek investment law reform face related challenges including inefficiency and nontransparency of government procedures that result in high operational costs as well as an uneven playing field for investors. In making a case for reform, develop messaging that demonstrates how the reform will support the progression of both good governance and the streamlining of bureaucratic procedures.
4. How does the government stand to gain from reform?

Provide a projected cost/benefit analysis as well as compelling quantitative data from other competing investment destinations that provide a direct link or correlation between investment law reform and increases in the creation of formal employment, revenue, investments, economic growth, and so forth.
5. How is a support coalition built?

Sequence or cascade the messaging and outreach campaign so that key individuals and groups feel included and are addressed, or targeted at strategic intervals. The objective is to build a broad-based coalition to support a specific reform based on mutually reinforced self-interests, so the messaging must explain how the reform will provide direct and or relevant benefits for each constituency.

Deliver presentations that provide a cost/benefit analysis benchmarking the country against good global practice as well as relevant competing investment destinations and juxtapose those against both the current and the recommended regulatory regimes.

unemployment is estimated at well over 80 percent, the private sector has been largely uncompetitive due to infrastructure and capacity constraints. It was important therefore that the reform process show how and who the reform would benefit– the domestic entrepreneur, was the priority and the economy was secondary. The

communications strategy used the findings of a cost/benefit analysis as evidence of the urgency of reform and the opportunities reform would deliver.

It is important to “think strategically...and respond strategically.” The checklist in Box

Box 47. “To Do” Checklist

- Include a strategy for reform enactment in the diagnostic review. Mapping and understanding key stakeholders in a country will help to identify current and potential champions and challengers of reform, synergies, divisive issues, and potential areas for compromise. The results of the stakeholder mapping should help champions of reform to anticipate the challenges and when and how to preempt these.
- Ensure that staff who interface regularly with the client government can recognize and appreciate changes in the political economy and provide timely analysis to inform calibration of the reform communications strategy.
- Refer to external investment as international and not “foreign” in countries where there is an antipathy to foreign investors. Several developing countries have a large Diaspora community and subregion neighbors that are a potential pool of investors. These two groups are not subject to the same antipathy as “foreign” investors.
- Emphasize that responsible and quality investors, small or large, domestic or international, seek the same conditions to commit long-term investment – efficiency, transparency, and predictability.
- Link investment law reform to identified national priorities. Several developing countries have a ‘Vision 2020’ or other publicly expressed national vision. Usually, these visions broadly seek to industrialize and diversify the economy, improve efficiency in government and business, and reduce corruption, resulting in increased investment, the creation of employment, and resultant reduction of poverty. Explain how the investment law will help deliver on these agreed priorities.
- When you have identified the champions in government, the private sector, the legislature, media, civil societies, and academia, listen to them. Engage them in the reform communications strategy, build their capacity, and support them to lead and advance the public debate. Local ownership adds inestimable credibility and value.
- Know when and how to support the champions to address issues raised by opponents; don’t leave flawed arguments and public pronouncements unchallenged. In the absence of proactive and relevant communication, often-repeated falsehoods become “facts.”
- Understand when the champions should engage quietly and when to advocate publicly for reform. Leave room for public challengers to retreat with dignity and credibility.

Box 48. Steps to Legislative Drafting

First step: Review the investment policy and law to determine what needs to be amended.

Second step: Revise or assist in drafting the investment policy and law. This will entail:

- **Preparation of a report** based on the key principles. This report will be prepared through an initial study of the investment policy and law and its related regulations and investment-related clauses of various other laws, in the light of international good practice.
- **Consultations** using the principles of the report as an initial basis for discussion with key stakeholders, including (i) relevant governmental agencies, ministries, in particular the ministries of commerce, industry, labor, and finance; (ii) representatives of the private sector; and (iii) current foreign investors. Consultations will take the form of direct interviews and meetings (government), surveys (actual and deterred private investors), and workshops (local private sector).
- **Preparation and presentation** of a final report to the government

47 lists steps by which to implement this consensus-building component based on communications.

Policy Development and Legislative Drafting

Once policymakers have agreed on the investment policy and engaged the support of stakeholders, drafting the law begins. The best way to accomplish the actual drafting is for the government to hire a local law firm recognized for its expertise in drafting investment laws. International advisers should also be consulted to provide inputs based on other country experiences, if local lawyers are not familiar with those. Use of experts should avoid mistakes and ambiguities in the final document.

“Post-enactment” Assistance

After the enactment of the new investment code, the client government may need to do a range of supplementary work to facilitate the law’s successful implementation.

Additional assistance can consist in support to the government to prepare:

- Implementing regulations,
- Amendments to other relevant legislations and regulations in accordance with the policy and investment law reform,
- New administrative procedures to ensure that the impact of the new law and regulations reaches the operational interface between the investors and government, and
- Training the government officers who will be responsible of the implementation.

CHAPTER 10: MONITORING AND EVALUATION

In the past few years, the development community and WBG have emphasized the importance of M&E. The information that comes out of the M&E process helps demonstrate whether projects accomplished their stated objectives and whether these accomplishments were beneficial for the client. It also informs future project design and provides justification for replication of successes.

It is useful to start with a simple question: What is M&E and why is it important? (IFC, GTZ, and DFID 2008, 21).

Monitoring is the collection and analysis of information to track progress in the implementation of the set-targets; answering the question “Did we deliver?”

Evaluation is the assessment of the implementation and the results; it answers the question “What has happened as a result?” (IFC, GTZ, and DFID 2008, 21).

M&E is important for the following main reasons:

- (a) It is a reporting tool that demonstrates results, making the project accountable to governments, beneficiaries, development partners, taxpayers, implementing institutions, donors, and other key stakeholders. Without tangible results being demonstrated, there will be no recognition to the project.
- (b) It provides means for learning from experience and, as a result, helps:
 - Improve service delivery,
 - Plan and allocate resources in a way that makes the greatest impact.

In essence, M&E demonstrates a link between:

- the reforms recommended through our advisory work, and
- the desired positive results and impacts that the project aims to achieve (for example, private sector led economic development).

However, for investment policy and law reforms M&E, the direct link between the reforms recommended and the impacts is difficult to establish. Impact will depend on and be the result of other reforms to factors that also affect the investment climate. Therefore, for investment policy and law reforms, the assessment will only cover the outcomes (that is, whether the recommendations were adopted.) In the example of Turkey, reviewed under Appendix 2, several recommendations were made, such as abolishing investment screening, and granting key guarantees that appear in the new law, passed on June 5, 2003.

It should be noted that expected outcomes can take several years to materialize. For example, Guinea-Bissau adopted its new investment code three years after the initial reviews, and two years after IC provided technical assistance to the drafting process. Many delays find their source in the political situation – political instability, or regime change by election or by force. Sometimes, the government has not assessed accurately the level of resistance or the country's readiness to effect this policy change. Sometimes, insufficient communication to build support and consensus for the reform can explain the time lag.

The IFC's standard M&E framework provides tools that permit each product to capture and assess results. The frameworks include a model that summarizes the kind of outputs, outcomes, and impacts that should ideally result from the implementation of a project through a series of indicators that are product specific. Indicators are standardized between the products to facilitate interproject and interclient tracking, consolidation, and comparisons. A project manager will need, however, to determine which indicators are the most appropriate to measure the achievement of the intended results for his project.

The model most appropriate to investment policy and law reform is presented below.

Tracking outputs, reform outcomes, and impacts through indicators:

The key components of the standardized matrix are inputs, outputs, outcomes, and impacts.

- **Outputs** are deliverables required to meet short-term project objectives, such as reports, training events, recommendations, and so forth.
- **Outcomes** are client actions supported by the team efforts leading to a reform. A reform is a significant change in a country's business environment that leads to increased private sector investments and job creation, along with their potentially beneficial results for overall economic development. Reforms are therefore essential outcomes of projects and in particular of investment law and policy reform projects.
- **Impacts** are aggregate results often over the longer term such as reduced costs to firms, increased private sector investments, more jobs, and increased savings for the private sector through streamlined business regulations. While investment law and policy reform trigger the impacts mentioned above, it is often difficult to establish a direct relationship between the investment law and policy reform, and the impacts, which depend on other factors as well. Therefore, for investment law and policy reform projects, impacts will not have to be directly measured by the team manager and do not have to be included in the below standard models.

The three matrices below for investment law and policy reform projects represent the different scales for such reform initiatives – desk review, medium-scale, and large-scale projects. The lists of indicators are not exhaustive but are the most appropriate that a project manager could use.

Standard Matrix for Project Design, Monitoring & Evaluation

Product: Investment Policy and Law Reform – Desk Review

Expected project components/activities	Performance Indicators		
	Expected output	Expected reform outcome	Expected impacts
1. Evaluating the government's request 2. Determining degrees of engagement and funding	<ul style="list-style-type: none"> ▪ Number of entities receiving advisory services [TARGET] ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices etc. [TARGET] 		
3. Report (Aide-memoire)	<ul style="list-style-type: none"> ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices etc. [TARGET] ▪ Number of new laws /regulations /amendments drafted or contributed to drafting [TARGET] ▪ Number of procedures, policies, practices proposed for improvement or elimination [TARGET] ▪ Number of workshops, training events, seminars, etc. [TARGET] ▪ Number of participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of participants providing feedback on satisfaction [TARGET] ▪ Number of participants reporting satisfied or very satisfied with workshops, training events, seminars, conferences [TARGET] ▪ Number of women participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of media appearances [TARGET] 	R: Improved regulatory framework related to investment generation (0=No, 1=Yes) R: Improved institutional framework related to investment generation (0=No, 1=Yes) R: Implementation or improvement of industry-specific procedures, policies, and practices (0=No, 1=Yes) R: Increase or diversification in the output of relevant sectors resulting from the adoption of industry-specific regulatory or procedural changes (0=No, 1=Yes)	

The main outcome for investment law and policy reform would be the IC Result: "Improved regulatory framework related to Investment Generation." The difference between the three matrices would be that the outcome would be expected at different stages: for desk review, at the report submission stage; for a medium-scale project, at the enactment of the new law that has been steered through the enactment processes; and for large-scale projects, after post-enactment assistance is completed.

Standard Matrix for Project Design, Monitoring & Evaluation

Product: Investment Policy and Law Reform – Medium-scale Project

Expected project components/activities	Performance Indicators		
	Expected output	Expected reform outcome	Expected impacts
<p>I Project cycle</p> <p>1. Evaluating the government’s request</p> <p>2. Determining degrees of engagement and funding</p> <p>3. Pre-field research</p> <p>4. Scoping mission</p> <p>5. Report (Aide-memoire)</p>	<ul style="list-style-type: none"> ▪ Number of entities receiving advisory services [TARGET] ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices, and so forth [TARGET] ▪ Number of new laws/ regulations/ amendments drafted or contributed to drafting [TARGET] ▪ Number of procedures, policies, practices proposed for improvement or elimination [TARGET] ▪ Number of workshops, training events, seminars, and so forth [TARGET] ▪ Number of participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of participants providing feedback on satisfaction [TARGET] ▪ Number of participants reporting satisfied or very satisfied with workshops, training events, seminars, conferences [TARGET] ▪ Number of women participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of media appearances [TARGET] 		
<p>II Drafting and promulgation of the law</p> <p>1. Planning for reform of the law</p>	<ul style="list-style-type: none"> ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices, and so forth [TARGET] ▪ Number of workshops, training events, seminars, and so forth [TARGET] ▪ Number of participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of participants providing feedback on satisfaction [TARGET] ▪ Number of participants reporting satisfied or very satisfied with workshops, training events, seminars, conferences [TARGET] ▪ Number of women participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of media appearances [TARGET] 		

<p>2. Policy development and legislative drafting</p>	<ul style="list-style-type: none"> ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices, and so forth [TARGET] ▪ Number of new laws /regulations / amendments drafted or contributed to drafting [TARGET] ▪ Number of procedures, policies, practices proposed for improvement or elimination [TARGET] 		
<p>3. Steering the new law through the enactment processes</p>	<ul style="list-style-type: none"> ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices, and so forth [TARGET] ▪ Number of workshops, training events, seminars, and so forth [TARGET] ▪ Number of participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of participants providing feedback on satisfaction [TARGET] ▪ Number of participants reporting satisfied or very satisfied with workshops, training events, seminars, conferences [TARGET] ▪ Number of women participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of media appearances [TARGET] 	<p>R: Improved regulatory framework related to investment generation (0=No, 1=Yes)</p> <p>R: Improved institutional framework related to investment generation (0=No, 1=Yes)</p> <p>R: Implementation or improvement of industry-specific procedures, policies, and practices (0=No, 1=Yes)</p> <p>R: Increase or diversification in the output of relevant sectors resulting from the adoption of industry-specific regulatory or procedural changes (0=No, 1=Yes)</p>	

With respect to medium-scale projects, where the involvement of the team goes beyond the submission of the report to assisting the government in steering the new law through the enactment processes, the outcomes are measured after enactment – a process that can take several years.

Standard Matrix for Project Design, Monitoring & Evaluation

Product: Investment Policy and Law Reform – Large-scale Project

Expected project components/activities	Performance Indicators		
	Expected output	Expected reform outcome	Expected impacts
<p>I Project cycle</p> <p>1. Evaluating the government's request</p> <p>2. Determining degrees of engagement and funding</p> <p>3. Pre-field research</p> <p>4. Scoping mission</p> <p>5. Report (Aide-memoire)</p>	<ul style="list-style-type: none"> ▪ Number of entities receiving advisory services [TARGET] ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices, and so forth [TARGET] ▪ Number of new laws /regulations /amendments drafted or contributed to drafting [TARGET] ▪ Number of procedures, policies, practices proposed for improvement or elimination [TARGET] ▪ Number of workshops, training events, seminars, and so forth [TARGET] ▪ Number of participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of participants providing feedback on satisfaction [TARGET] ▪ Number of participants reporting satisfied or very satisfied with workshops, training events, seminars, conferences [TARGET] ▪ Number of women participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of media appearances [TARGET] 		
<p>II Drafting and promulgation of the law</p> <p>1. Planning for reform of the law</p>	<ul style="list-style-type: none"> ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices, and so forth [TARGET] ▪ Number of workshops, training events, seminars, and so forth [TARGET] ▪ Number of participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of participants providing feedback on satisfaction [TARGET] ▪ Number of participants reporting satisfied or very satisfied with workshops, training events, seminars, conferences [TARGET] ▪ Number of women participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of media appearances [TARGET] 		

<p>2. Policy development and legislative drafting</p>	<ul style="list-style-type: none"> ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices, and so forth [TARGET] ▪ Number of new laws/ regulations/ amendments drafted or contributed to drafting [TARGET] ▪ Number of procedures, policies, practices proposed for improvement or elimination [TARGET] 		
<p>3. Steering the new law through the enactment processes</p>	<ul style="list-style-type: none"> ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices, and so forth [TARGET] ▪ Number of workshops, training events, seminars, and so forth [TARGET] ▪ Number of participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of participants providing feedback on satisfaction [TARGET] ▪ Number of participants reporting satisfied or very satisfied with workshops, training events, seminars, conferences [TARGET] ▪ Number of women participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of media appearances [TARGET] 	<p>R: Improved regulatory framework related to investment generation (0=No, 1=Yes)</p> <p>R: Improved institutional framework related to investment generation (0=No, 1=Yes)</p> <p>R: Implementation or improvement of industry-specific procedures, policies, and practices (0=No, 1=Yes)</p> <p>R: Increase or diversification in the output of relevant sectors resulting from the adoption of industry-specific regulatory or procedural changes (0=No, 1=Yes)</p>	

<p>4. Post-enactment assistance</p>	<ul style="list-style-type: none"> ▪ Number of reports (assessments, surveys, manuals) completed [TARGET] ▪ Number of reports (desk reviews/aide memoire reports, concept notes) proposing recommendations for improvement of policies, laws, regulations, amendments, procedure, practices, and so forth [TARGET] ▪ Number of new laws /regulations /amendments drafted or contributed to drafting [TARGET] ▪ Number of procedures, policies, practices proposed for improvement or elimination [TARGET] ▪ Number of workshops, training events, seminars, and so forth [TARGET] ▪ Number of participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of participants providing feedback on satisfaction [TARGET] ▪ Number of participants reporting satisfied or very satisfied with workshops, training events, seminars, conferences [TARGET] ▪ Number of women participants in workshops, training events, seminars, conferences [TARGET] ▪ Number of media appearances [TARGET] 	<p>R: Improved regulatory framework related to investment generation (0=No, 1=Yes)</p> <p>R: Improved institutional framework related to investment generation (0=No, 1=Yes)</p> <p>R: Implementation or improvement of industry-specific procedures, policies, and practices (0=No, 1=Yes)</p> <p>R: Increase or diversification in the output of relevant sectors resulting from the adoption of industry-specific regulatory or procedural changes (0=No, 1=Yes)</p>	
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For large-scale projects, outcomes can be measured at two points: after the new law is enacted (as with medium-scale projects), and after post-enactment assistance.

APPENDICES

APPENDIX I: GUIDANCE NOTE

PREPARING AN INVESTMENT POLICY STATEMENT

AUGUST 2006

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Purpose of this guidance note

This guidance note briefly explains the intended purpose of an Investment Policy Statement (IPS) and outlines a process for preparing one.

1. The importance of policy and administrative practices

Policies and administrative practices are important factors in influencing flows of foreign direct investment (FDI). According to the United Nations Conference on Trade and Development:

“To attract FDI and benefit from it, governments take a range of measures. One of the first things governments wishing to attract FDI can do (and should do) is to establish an enabling policy framework for FDI. Of course, they need to recognize that the FDI policy framework is but one of the factors that attract FDI inflows. It is a necessary but not a sufficient condition to influence locational decision. Business facilitation measures – the efficiency and efficacy of the administrative system that impinges on the entry and operations of TNCs (trans national corporations), as well as investment promotion (including incentives available to foreign investors) – can also influence FDI inflows.”¹

¹ United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 1999, Foreign Direct Investment and the Challenge of Development*, 1999.

Investment friendly policies promote economic growth by providing a predictable environment which attracts investment in productive business activities. The pattern of recent FDI flows also supports the conclusion that facilitative policies serve to attract more and better foreign investments.

Recognising this, countries, developed and developing, have increasingly moved towards introducing more open and “market or investor-friendly” policies and associated legislation, regulations and administrative practices. These include, among others: sound macroeconomic management, reducing restrictions on admission and establishment, promoting competition, building human capital, supporting linkages between foreign and domestic enterprises, and promoting FDI etc.²

The purpose of an investment policy statement

An investment policy statement (IPS) is a document that states Government’s policy on investment. It is focused particularly on direct investment, includes all policies relevant to investment such as employment, taxation, as well as policies that specifically address foreign direct investment such as the issuing of foreign investment certificates or licenses.

The IPS should be concise, written in plain language. It should also accurately reflect the current situation, but may forecast anticipated policy changes.

The purpose of the IPS is to clarify and enhance understanding on the part of government officials and private investors – foreign and domestic

– of Government’s policies on investment. A summary of the range of areas or issues that might form part of a country’s investment policy is set out in Appendix A.

For each issue, the IPS should explain Government’s objectives and why it is pursuing this course of action, as well as briefly describe the strategy(s) and process by which the objectives are being pursued. For example, with respect to the issue of work permits for expatriates, the policy might include the following elements:

- creation of citizen employment is a key government objective
- however, government recognises that the citizen work force may not necessarily contain people with the appropriate skills
- consequently, it will automatically provide work permits for any professional or technical position applied for by an investor
- the request is to be submitted in writing to the Commissioner of Labour and the investor need only demonstrate that the position to be occupied by the work permit holder is a permanent professional or technical position in the investment
- the work permit will be issued for 2 years but be renewable upon application
- short term specialists may work in the country for up to a 3 month period on a visitors visa obtainable on presentation of a letter or contract of appointment from the investor at Immigration on arrival.

Guiding principles for an IPS

Global good practice investment principles are annexed at Appendix B.

² These policy developments are discussed in United Nations Conference on Trade and Development (UNCTAD), World Investment Report 2003, FDI Policies for Development: National and International Perspectives, 2003.

While the principles are intended to focus primarily on foreign investment, several are equally applicable to all investment, not just foreign investment. Further, they are not all just principles for inward foreign investment, but include outward investment, protection of public interests and, importantly, the style of the policies themselves.

One way to look at the principles, therefore, is in five categories. They are those that deal with:

- government policies for foreign investment
- government policies for outward investment
- the protection of public interest
- the in-country behaviour of foreign investors
- the style of a government's investment policies.

Each of these is discussed in more detail below.

Foreign investment policy principles

There are eight principles that address policies for foreign investment. That these represent two-thirds of all the global good practice principles is a strong indicator that policies relating to FDI inflows have a high level of significance.

The principles are also important because developing nations are interested to attract foreign direct investment (FDI) into most sectors and activities of their economies. This reflects a growing awareness amongst governments that citizen investment alone cannot achieve the desired level of economic development that is wanted. If nations are to have adequate and sustainable standards of living, then FDI is required to help fill the development gap.

The inward foreign investment principles are:

- no discrimination based on country of origin
- equal treatment with nationals within the host country
- expropriation and compensation only for public purposes under law
- avoidance of performance requirements that distort or limit trade or investment
- prompt repatriation of funds in freely convertible currency
- appropriate dispute resolution practices
- permitted entry and sojourn of key foreign investment personnel
- avoidance of double taxation.

International experience has demonstrated that investment policies, which reflect the attributes represented by these eight principles, contribute substantially to an investment environment that is attractive to foreign investors. They can signal a host country's attitude toward investors. In brief, their inclusion can raise the level of certainty and predictability for investors that they can operate effectively and profitably, that they can distribute their investment returns as they wish, and that they are welcome in the community.

However, it is important to recognise that, while these eight principles provide benefits to foreign investors, their application acts to enable investment flows – they will not guarantee them.

Preparing and subsequently documenting and consolidating investment policies into an IPS is not an end in itself. An IPS will help make a country's policy, legislative and regulatory framework more stable, certain and predictable. It has to be complemented by wider economic determinants that encourage FDI – a favourable investment environment.

It is the combination of a favourable policy and economic environment that encourages inward FDI flows. Where these inflows occur, this increases opportunities for a host economy to take advantage of wider benefits that can be generated. Typically, these benefits are manifest in the creation of greater employment opportunities for citizens, increased levels of exports and associated foreign exchange earnings, transfer of greater managerial and technological skills and other spin-off activities. Tax revenues will be also be enhanced, disposable income will rise and greater choice in goods and services at lower costs will be available for all citizens.

Outward investment policy principle

There is only one principle that focuses on outward investment. It seeks to minimise any restrictions or barriers that impede the outward flow of investment from a country.

Many citizens of developing economies might wonder why outward investment is an issue that needs to be addressed. Many would believe that domestic investments (both foreign and citizen owned) are needed at home and that few such established investments would desire to go elsewhere. Their perception is likely to be that developed countries, rather than developing countries, provide most foreign investors.

This is not the reality, however, for even investors in the less developed countries sometimes need to locate their investments elsewhere. As economies develop, investment opportunities change and some sectors or activities become less competitive. Investments in such sectors need to be able to relocate easily, if they are to remain profitable. As an example, Mauritius once had low investment levels and high unemployment. Through development of an attractive investment environment and effective investment promotion, that country was able to attract FDI in labour intensive assembly industries.

So effective has Mauritius been that unemployment levels have dropped enormously. However, as labour availability tightened, wages have been forced to rise so that Mauritius is now less attractive as an investment location for labour intensive industries. Some in those industries now need to move elsewhere where labour is more cost-effective. Mauritius' loss in these sectors, however, will be some other country's gain.

The Mauritius economy, though, will now have attributes that are attractive to other types of investment. Development will continue, but with less contribution from labour intensive investments. The country is, in fact, seeking to move to higher technology industries.

It is worth noting that some level of intra-regional investments has been realised in certain Pacific countries. The leading countries involved in such exchanges are Fiji and PNG. Investors from the two countries are also known to have diversified into other Pacific countries such as Samoa, Tonga and Vanuatu.

In summary, this principle seeks to facilitate investment through re-location. If countries constrain this movement, economies can become stifled. The severe restrictions placed on outward investment in Zimbabwe after independence, and the deleterious impact this had on productivity in that previously vibrant economy, is testament to the appropriateness of adopting this principle.

The protection of public interest

Only one principle seeks to protect the public interest. It encourages governments not to provide investment incentives that relax public health and safety or environment standards. While this principle is worded specifically to address incentives for FDI, it is just as applicable for citizen owned investments.

Many developing countries do have domestic legislation that protects public health and safety and the environment. However, there are examples where standards appear not to have been maintained for foreign investments. These have been mostly in investments that exploit natural resources, particularly mining and forestry.

Whether the failure to achieve standards has resulted from investment incentives that have been provided or from a failure to monitor compliance with domestic legislation is not known. However, if incentives are to be provided it is likely that the long-term burden on society will be large and will outweigh the short-term returns from exploitation, without maintaining adequate standards.

In-country foreign investor behaviour principle

There is one principle under this category. It states that citizens are much more accepting of foreign investment if foreign investors abide by the laws of the land. Although aimed at the behaviour of foreign investors, it is also directed at governments that exempt foreign investors from local laws. This is usually because of some notion that some foreign investors will not invest unless such exemptions apply, or because of rent seeking behaviour by legislators.

If it is appropriate for citizen owned investments to abide by domestic laws, then the laws should apply equally to all foreign investors. Those foreign investors that are not prepared to abide by appropriate domestic legislation should not be encouraged to invest by exemptions. Further, those that do breach domestic laws should be penalised as would any citizen owned investment.

Investment policy style principle

There is just one principle under this category,

and it is a particularly important one. It encourages governments to ensure that all investment policies and the laws, regulations and administrative procedures that arise from them, are transparent.

Complete transparency means certainty for investors, whether foreigners or citizens, and no discretion and no rent-seeking behaviour. While transparency alone does not make bad policies good, its presence will greatly enhance any investment environment.

General good practice characteristics

Good practice foreign investment policies, legislation and associated administrative practises, including IPS, have certain common characteristics. They are:

- transparent:
- publicly documented, so that any investor can readily ascertain the policies and the procedures to follow in order to invest
- non-discretionary, so that decisions are taken on objective criteria
- consistently applied, so that there is no uncertainty in the outcome from following them
- complete, so that potential investors know the full situation and there will be no surprises for them
- simply stated, so that they can be easily understood by everyone
- unambiguous, so that the meaning is indisputable.

Good practice administrative procedures, implementing policy, legislation and administrative

practices are also characterised by being:

- fast – the process does not adversely impact on the timing of private sector investment decisions
- efficient – the compliance costs to investors and administrative costs to government are minimised.

2. Considerations in preparing an IPS

Preparing an IPS in practice

An IPS is best developed through an inter-departmental committee comprising government officials. This brings together all key government agencies playing a role in investment, creates a champion group that will push the creation of the IPS and take ownership over the document once it is produced. The committee format also provides an opportunity to air conflicts that may arise and resolve them.

Developing an IPS is typically an iterative process that involves preparation, review and revision of numerous drafts. Once the content is confirmed by all government agencies it can then be put to the inter-departmental committee, followed by Cabinet for acceptance. Once accepted by cabinet the IPS should be publicly released.

An IPS is not a one-off document – it should undergo review and update on an ongoing basis.

Stages in preparing an IPS

There are generally three stages involved in developing an IPS:

Stage 1

Initially, emphasis is placed on ensuring that policy statements are accurate, clear and comprehensive.

Stage 2

Once transparency has been achieved, policy makers should consider how the statements adhere to accepted international standards related to investment (see Appendix B). Consideration should therefore be given to ensuring that the policy statements are in line with these principles, and where they are not consistent, how they might be brought into line.

Stage 3

Consideration should be given to how effective the policies are in creating a climate that is attractive to private sector investors. This will require dialogue with investors (domestic and

Table 1: Tasks in completing an IPS

TASK	SUB-TASKS
1. Establish a government committee to oversee IPS preparation	Is there an interdepartmental committee already in place who can play this role? If so, invite them to assume responsibility for the IPS. If not, which government departments should be included on such a committee? Develop a list of candidates and get their agreement to be involved.
2. Convene an initial meeting of the committee	Invite the committee members to attend a short meeting, i.e. 1-2 hours. The meeting will briefly explain the purpose of the IPS, the format it will take, and how it will be prepared. In addition, the meeting should decide which investment related areas (see Appendix A) should be included in the IPS.

3. Gather information from government departments	<p>Identify a list of government officials responsible for each of the areas to be included in the IPS.</p> <p>Contact the officials and set-up meetings to gather information. In general, it will be necessary to meet with officials responsible for the following general areas:</p> <ul style="list-style-type: none"> • Investment promotion, i.e. Investment Promotion Authority • Investment incentives, i.e. Ministry of Finance • Expatriate work and residency permits, i.e. Immigration Department • Foreign investment approval and special restrictions imposed on foreign investors, i.e. Ministry of Commerce • Taxation, i.e. Ministry of Finance • Restrictions on foreign investors borrowing funds locally, i.e. Ministry of Finance • Restrictions on foreign investors access to foreign exchange and repatriating funds, i.e. Central Bank, Ministry of Finance • Customs procedures and import/export duties and fees, i.e. Customs Department • Access to land and office/factory space, i.e. Department of Lands • Basic utilities, i.e. Government departments or agencies responsible for telecommunications, electricity and water • Government guarantees provided to investors, i.e. Attorney General <p>Meet with officials, gather information and prepare draft statements for each of the agreed on investment policy issues.</p>
4. Confirm accuracy of policy statements	<p>Forward draft statements about investment issues to responsible government departments requesting confirmation of their accuracy and completeness.</p> <p>Revise policy statements based on feedback.</p>
5. Prepare draft NIPS	<p>Organise policy statements into a single IPS document.</p> <p>Assess the IPS against the international good practice investment principles (Appendix B), and identify any areas of inconsistency and how they might be addressed.</p>
6. Secure government approval of draft NIPS	<p>Circulate draft IPS to committee members.</p> <p>Convene committee meeting to discuss draft IPS and areas, if any, that are inconsistent with the international good practice investment principles.</p> <p>Agree on revisions to IPS.</p> <p>Revise IPS and submit to Cabinet for review and approval.</p>

foreign) to identify areas of key concern and then follow up action to develop and implement strategies to address the concerns.

The terms of reference for this particular initiative are focused on stages 1 and 2. If agreed to by the interdepartmental committee and Cabinet, the IPS would be publicly released at this point. However, there still may be ways to enhance some of the policies included in the IPS. A separate, additional review process would need to be undertaken to address the third stage mentioned above.

Process for completing an IPS

The six main tasks that need to be completed in order to complete the IPS are in outlined in Table 1, in chronological order. Each of these main tasks is then further broken down into smaller tasks that will need to be acted on.

Appendix A: Schedule of areas included in an IPS

While the following list is intended to be comprehensive, it should be adjusted to fit with a country's individual circumstances.

The items are not listed in any order of priority.

Promotion/facilitation arrangements

- Investment Promotion Agency

Investment incentives

- Availability
- Application and approval procedures

Work and residency

- Work permits for expatriates
- Residency for expatriates and families

Investment conditions

- Sector investment restrictions
- Export requirements for foreign investors
- Local ownership requirements
- Requirements for training of locals

Taxation

- Taxation of FDI
- Rules for taxation of individual expatriates

Finance

- Foreign exchange availability, accounts
- Local borrowing rules for foreign investors

- Foreign borrowing restrictions
- Repatriation of funds

Importation and exportation

- Customs clearance procedures
- Export processing or customs free zones
- Import or other import related duties
- Export or other export related charges

Industrial infrastructure

- Leasing of land
- Factory space
- Utility connections

Guarantees

- Expropriation/Compensation
- Intellectual Property
- Dispute Settlement
- Equal Treatment

Foreign investment approval process

- Regulatory procedures foreign investment approval

Appendix B: International good practice investment principles

Transparency

Make all laws, regulations, administrative guidelines and policies pertaining to investment in their economies publicly available in a prompt, transparent, and readily accessible manner.

Non-discrimination between source countries

Extend to investors from any economy treatment in relation to the establishment, expansion and operation of their investments that is no less favourable than that accorded to investors from any other economy in like situations, without prejudice to relevant international obligations and principles.

National treatment

With exceptions as provided for in domestic laws, regulations and policies, accord to all foreign investors in relation to the establishment, expansion, operation, and protection of their investments treatment no less favourable than that accorded in like situations to domestic investors.

Investment incentives

Do not relax health, safety, and environment regulations as an incentive to encourage foreign investment.

Performance requirements

Minimise the use of performance requirements that distort or limit the expansion of trade and investment.

Expropriation and compensation

Do not expropriate foreign investments or take measures that will have a similar effect, except for a public purpose and on a non-discriminatory basis, in accordance with the laws of each economy and principles of international law, and against the prompt payment of adequate and effective compensation.

Repatriation and convertibility

Further liberalise towards the goals of the free and prompt transfer of funds related to foreign investment, such as profits, dividends, royalties, loan payments and liquidations, in freely convertible currency.

Settlement of disputes

Accept that disputes arising in connection with a foreign investment will be settled promptly through consultations and negotiations between the parties to the dispute or, failing this, through procedures for arbitration in accordance with international commitments or through other arbitration procedures acceptable to both parties.

Entry and sojourn of personnel

Permit the temporary entry and sojourn of key foreign technical and managerial personnel for the purpose of engaging in activities connected with foreign investment, subject to relevant laws and regulations.

Avoidance of double taxation

Endeavour to avoid double taxation related to foreign investment.

Investor behaviour

Acceptance of foreign investment is facilitated when foreign investors abide by the host economy's laws, regulations, administrative guidelines and policies, just as domestic investors should.

Removal of barriers to capital exports

Accept that regulatory and institutional barriers to the outflow of investment will be minimised.

APPENDIX 2: CASE STUDY: POSITIVE OUTCOMES AND PRELIMINARY IMPACT OF INVESTMENT LAW REFORM IN TURKEY

In 2002, with a view to encouraging Foreign Direct Investment (FDI) into its economy, the Government of Turkey decided to modernize its FDI legislation, the Law for the Encouragement of Foreign Capital of January 18, 1954 (No. 6224) (1954 Law), which had outlived its usefulness. The Government solicited the assistance of the Investment Climate Advisory Services (IC) of the World Bank Group (WBG) in diagnosing issues in the 1954 Law, and an IC team spent several months advising the Under-Secretariat for Treasury (General Directorate on Foreign Investment, GDFI) and consulting with public and private sector stakeholders, resulting in proposed changes and preparation of a new Law.

The main recommendations for the revision of the 1954 Law included the following:

- Confirmation, introduction, and reinforcement of the fundamental guarantees protecting investors, related to expropriation, national treatment, dispute resolution, and land access.

- The abolition of the foreign investment screening and approval process and its replacement with a simple notification system.
- The removal of the \$50,000 minimum capital requirement for FDI projects.

The new FDI law was enacted; Law No. 4875, dated June 5, 2003, took effect on June 17, 2003.

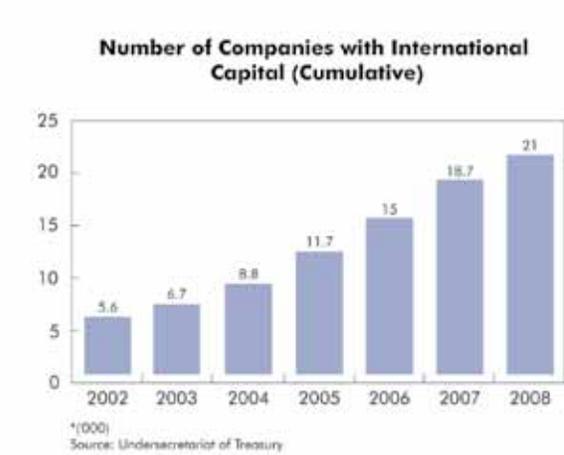
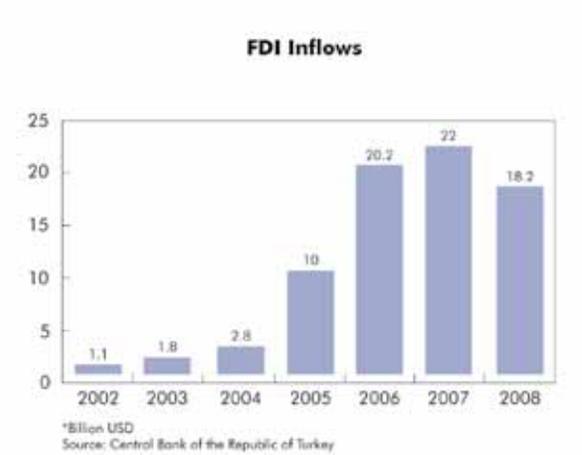
It is always a challenge to evaluate or measure the economic impact of a legislative reform, especially when it is one of several reforms taking place in a given period of time. However, after the 2003 reform, several economic indicators in Turkey improved, and the change is attributed by the Turkish authorities themselves, at least in part, to the reform of the investment law:

- FDI inflows: FDI inflows increased dramatically after 2003, as shown in the figure on the left below.

- Companies with foreign capital: The number of companies with foreign capital also increased dramatically after 2003, as shown in the figure on the right.
- Gross domestic product (GDP): “In recent years, the Turkish economy has displayed a high growth performance ... it has become

one of the fastest growing economies in the world. The annual average real GDP growth rate, which was 0.8% during the period 1998 to 2002, reached 7% in the period 2002 to 2007.”¹

¹ <http://www.invest.gov.tr>



Source: <http://www.invest.gov.tr>

APPENDIX 3: LESSONS OF EXPERIENCE: REVIEW OF LIBERIA'S FDI ENTRY EXCLUSIONS*

Section 12 of Liberia's General Business Law of 1975 as amended in 1998 restricts 26 areas of economic activity to Liberians¹. (The Liberian Constitution limits citizenship to persons "who are Negroes or of Negro descent"² – whether such persons acquire citizenship by birth or by naturalization).

The reserved sectors are block-making with cement, clay, or like materials; supply of sand, stone, and granite; operation of gas stations; peddling; ice cream manufacturing; commercial printing; travel agencies; advertising agencies; graphics and commercial arts; distribution in Liberia of locally manufactured products³; cinemas; production of poultry products;

importation or sale of secondhand or used clothing; retail sale of rice; ice making or sale of ice; operation of water purification or bottling plants valued at less than US\$100,000 or the sale/distribution of water purified in Liberia; importation and sale of used cars; tire repair shops; auto repair shops with investment of less than US\$50,000; entertainment centers not connected with established hotels; retail sale of animal and poultry food; taxi and trucking; shoe repair shops; retail sale of timber and planks; bakeries; and retail sale of pharmaceuticals.

This formulation excludes all foreigners, and particularly affects the significant communities of Middle Eastern (Lebanese) and Asian (Indian and Chinese) entrepreneurs, from participating in those sectors, even though several families within such communities have been in Liberia for decades. Heavy penalties that may be meted out in the event of violation include fines, imprisonment, and confiscation of assets of the erring enterprise⁴.

¹ See Section 1 of Act to Amend Chapter 12 of the General Business Law with Respect to Business Regulations, 1998. See also Economic/Commercial Section, United States Embassy, Monrovia, Liberia, *Doing Business in Liberia*, 2006, p.18.

² See Article 27 of Liberian Constitution of 1984.

³ Nonindigenous manufacturers or other producers are not prevented thereby from transporting or otherwise distributing their products to Liberian citizens or qualified persons for resale.

* Section of a report presented to the government of Liberia on legal and regulatory framework for investment.

⁴ See Section 3 of Act to Amend Chapter 12 of the General Business Law, 1998.

The reasons for the imposition of restrictions in the above-listed sectors are said to be threefold⁵. First was the widely held sentiment that foreigners had taken advantage of the Liberian people and that there was a need for them to gain dominance over their own economy or at least be able to participate in a meaningful way. The second was the belief that non-Liberians owed loyalty elsewhere and contributed little to the growth of the economy. The third was the belief that the named sectors were necessarily small scale and required significantly less capital than other enterprises, putting them within the reach of Liberians.

Although the justification offered for such exclusionary policies was the economic empowerment of nationals of the country, evidence from research in Benin, Kenya, Senegal, Tanzania, Uganda, and Zambia shows that such policies have been detrimental to the national economy.⁶ What counts in assessing a social or economic policy is not the stated intentions of promoters, but the actual end results on the ground. It is useful to note therefore that:

- i. It is not the case that economic opportunities are finite and that the activities of nonindigenous entrepreneurs necessarily exclude indigenous entrepreneurs. Rather than penalizing nonindigenous business groups to promote indigenous entrepreneurs (as is often suggested by indigenous entrepreneurs and populist politicians), efforts should be made to improve information flows and create networks that replicate the supportive mutually dependent business cultures in which nonindigenous entrepreneurs thrive.⁷
- ii. Although the populist appeal of restricting areas of enterprise to indigenous

entrepreneurs is powerful, the conditions that have inhibited the growth of local entrepreneurs were not created by nonindigenous entrepreneurs. The reality is that African governments have, inadvertently or otherwise, created conditions under which nonindigenous entrepreneurs do better than indigenous investors.

- Notwithstanding the best intentions of African governments, administrative inefficiencies in registration and regulatory institutions create significant barriers to entry and compel most entrepreneurs to operate outside the formal sector. The resultant operational disadvantages, including the lack of access to capital, compel most indigenous entrepreneurs to remain small. This situation persists in spite of significant resources spent by governments and donors on support programs and cheap loans (which are often not repaid) because the underlying drivers of informality remain unaddressed.
- The overall complexity of the business environment in the countries reviewed induces entrepreneurs to devise means of circumventing processes – usually through bribery – thus encouraging a culture of corruption. Research suggests that most businesses in Africa operate outside the law in one or more aspects and are vulnerable to regulatory administrators, however minor the infraction.

⁵ Discussions with various entrepreneurs in Liberia.

⁶ See generally Benn Eifert, Alan Gelb, and Vijaya Ramachandran, *Business Environment and Comparative Advantage in Africa: Evidence from the Investment Climate Data*, Centre for Global Development, Working Paper Number 56, February 2005.

⁷ For instance, access to university education in the countries reviewed has been significant in determining the performance and rate of growth of indigenous enterprises. The reasons given are that university education permits an entrepreneur's entry into a network of business professionals similar to ethnic minority networks; engenders a network that is a potential source of finance; and enables a flow of information about firm performance, characteristics of the entrepreneur, and other vital data that enable lending, the supply of trade credit, and the transfer of technological know-how.

This vulnerability combined with the arbitrary nature of rule-enforcement attributable to poor governance results in firms being persecuted for operating in the same manner as other entrepreneurs in the same environment. This in turn perpetuates a vicious cycle that requires entrepreneurs to seek “protectors” in government or regulatory institutions, with attendant costs for such patronage.

- The traditional well-meaning offer of incentives for Foreign Direct Investment (FDI) have limited the ability of domestic firms to compete in the same sectors as FDI-funded enterprises. Several African investment promotion efforts have typically offered tax holidays and customs indemnities for FDI-funded enterprises while maintaining onerous financial and regulatory obligations for domestic firms⁸.
- World Bank estimates suggest that 80–90 percent of Liberia’s labor force operates informally. One reason for this is that there is little faith that public institutions will create an atmosphere of commercial stability and fairness. As a result, informal businesses must adapt to an unregulated environment, which creates unfair competition with formal firms, making efforts to formalize expensive and out of reach for many entrepreneurs. This phenomenon is most obvious for microenterprises that do not have the flexibility or margin to change their production and cost structures. Further exacerbating the situation is the fact that, on the government side, low capacity has resulted in nonimplementation of the law, which encourages/facilitates continued noncompliance.

iii. In the countries reviewed, network benefits within nonindigenous communities substitute for many of the dysfunctional elements of government administration/regulation or poor government services, and other obstacles such as limited access to external finance and poor avenues for dispute resolution. Nonindigenous-owned companies have, for network reasons, also tended to start larger operations with economies of scale, and grow faster. Available evidence confirms that nonindigenous entrepreneurs within networks have a much greater incentive to stick to their contractual boundaries because members of the network will enforce contracts and/or inflict penalties (including ostracism) for violations. Indigenous entrepreneurs are generally not bound by such enforcement mechanisms and do not benefit from a mutual sense of interdependence with other indigenous entrepreneurs.⁹ This creates a self-perpetuating cycle of nonindigenous entrepreneurs dealing only with each other and excluding indigenous entrepreneurs from their spheres of influence. Because of the same networks, nonindigenous communities often have access to more growth-relevant information than would be the case with indigenous entrepreneurs. Overt discrimination against such nonindigenous communities enhances their sense of encirclement and would strengthen their affinity to their institutions to the exclusion of others.

Undoubtedly, the argument for the retention of exclusionary policies in Liberia is politically powerful. It is useful however to recognize that:

- i. In the event of indigenous entrepreneurs lacking resources to develop businesses in the reserved sectors, such essential services as block-making with cement; operation of gas

⁸ Tax Incentives and Foreign Direct Investment - A Global Survey, ASIT Advisory Studies No. 16, UNCTAD, 2000. Full text of study available at www.unctad.org

⁹ Vijaya, Ramachandran Draft Paper, The Challenge of Growth in the African Private Sector, p 23.

stations; commercial printing; travel agencies; operation of water purification or bottling plants valued at less than US\$100,000; taxi and trucking; and retail sale of pharmaceuticals could potentially be unavailable.

- ii. Nonindigenous business communities tend to have tolerance for risk that has enabled them to contribute, significantly or otherwise, to economies of post-conflict territories through contribution to gross fixed-capital formation, income generation through employment, technology transfer, inflow of managerial capacity, and development of market knowledge¹⁰. In Liberia, the risk tolerance of such nonindigenous entrepreneurs as Lebanese and Indians make them likely, through investments, to be the greatest short-run source of growth, and it would be unfortunate if their endeavors were restrained from growing.
- iii. The view that the 26 sectors reserved to Liberian citizens by the General Business Law are generally small scale is not accurate. With the exception of shoe and tire repair shops, each of the listed enterprises is capable of development on a large scale. Indeed the listing of the many manufacturing enterprises is unfortunate, because it could potentially yield significant formal employment in a country that suffers from a high rate of informality.

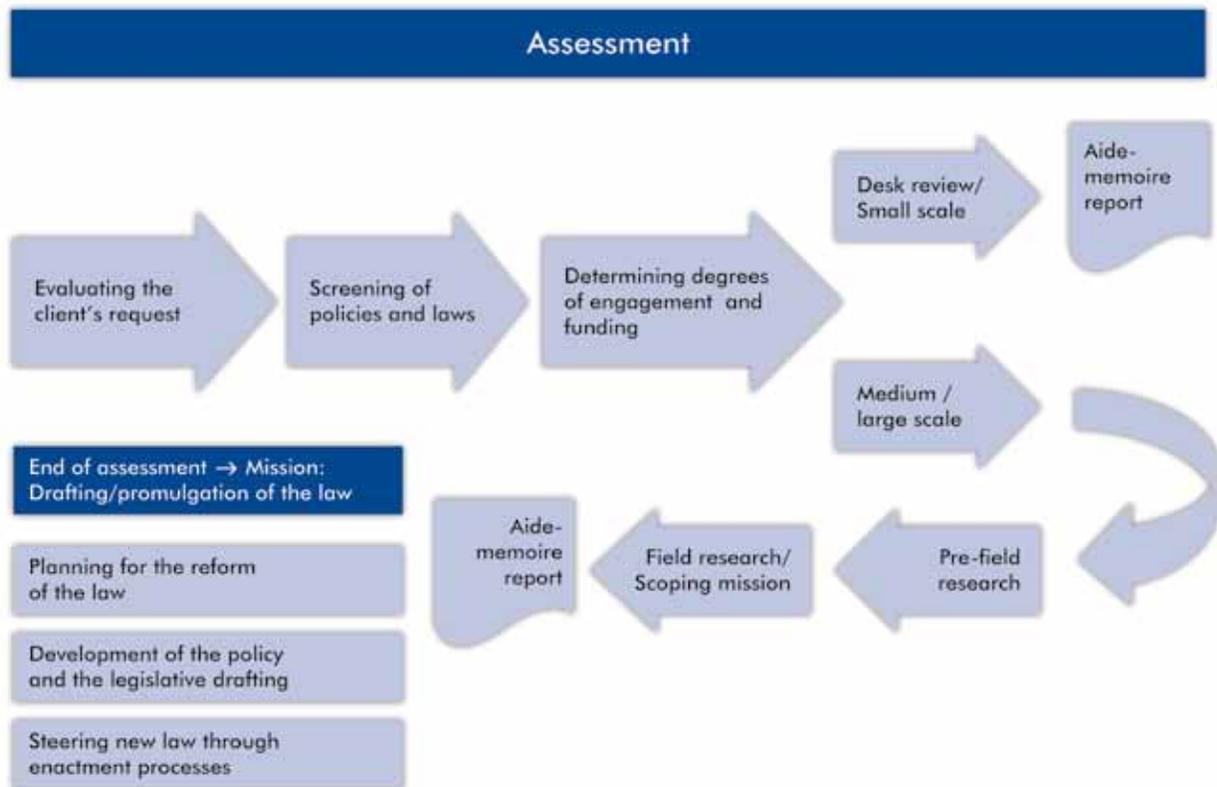
- iv. Given that Liberia seeks to prioritize investment attraction, it would be prudent for policymakers to ensure consistency between domestic investment policy and the body of international trade and investment rules such as exists under the World Trade Organization's (WTO's) Trade Related Investment Measures.¹¹ Unjustly discriminatory policies in Liberia's trade and investment policy are likely to be scrutinized under the WTO's Trade Policy Review Mechanism and penalized through the Ministerial Council, thereby retarding Liberia's integration into the international business community.

In light of the evidence that institutionalized distinctions between indigenous and nonindigenous investors do not yield the expected results, justifying the dispensation encourages the belief that certain categories of investors cannot expect rationally justifiable and equal treatment. Investment codes provide a signal to the world about the readiness of a country to be integrated into the international business community and have usually been one of the first major pieces of legislation promulgated by countries emerging from protracted conflict. Any entrenched substantively discriminatory policies against certain types of entrepreneurs based on race or ethnicity could lead to unfavorable perceptions in the international business community about Liberia as an investment destination and could hamper any drive of Liberian policymakers to attract investment.

¹⁰ Note examples of Sierra Leone and Afghanistan.

¹¹ WTO's Agreement on Trade-Related Investment Measures (Doha Round: 2001) proscribes such antiliberal policies as compelling local industries to exclusively use local inputs.

APPENDIX 4: ASSESSMENT AND MISSION



APPENDIX 5: TEMPLATE FOR ASSISTING IN THE EVALUATION OF THE CLIENT'S REQUEST

DOCUMENTING CLIENT REQUEST

<i>Date of first entry:</i>		
<i>Date of last modification:</i>		
<i>WBG staff doing the first entry:</i>		
<i>WBG staff responsible of last modification:</i>		
Client information	Input	Observations
Country:		
Region (If applicable):		
Institution:		
Main contact:		
Full name:		
Position:		
Phone:		
Fax:		
Email:		
Is the contacting person directly responsible for the request?		
If not, who is directly responsible for the request?		
Full name:		
Position:		

Phone:		
Fax:		
Email:		
Secondary contact		
Full name:		
Position:		
Institution:		
Phone:		
Fax:		
Email:		
Does client contact have a capacity for the request?		
Describe		
Client request		
Request for assistance date:		
Briefly describe the initial request:		
Is the request about policy reform, law reform, or both?		
Way of contacting the department		
How did client identify the Department?		
If contact with Department not direct, when was the Department made aware of request?		
If referred by WBG contact:		
WBG staff full name:		
WBG entity:		
WBG staff position		
WBG person department/area:		
Region:		
Phone:		
Fax:		
Email:		
Previous experience with Department		
Has this client had any previous experience with Department?		
If Yes:		
Last assistance request - work date/s		

Primary contact at Department:		
Full name:		
Position:		
Phone:		
Fax:		
Email:		
Previous experience with WBG		
Which WBG entities have or have had projects in the client country	World Bank: Provide links for the projects	
	IFC: Provide links for the projects	
	MIGA: Provide links for the projects	
	IC: Provide links for the projects	
Understanding the request/project demand		
Is the client's initial request clear and actionable by Department?		
If No, when was it clarified with the client?		
Is it clear and actionable now?		
If No, what changed to make it clear and/or actionable?		
Which other organizations has the client asked for assistance concerning this specific request?		
What other international agencies are working in the country/region concerning this specific request for assistance?		
Is FDI present in country/region?		
Are there other national/regional organizations involved or as direct beneficiaries of this request for assistance? If Yes, which?		

DECIDING IF PROJECT IS OF INTEREST TO Department

Country:		Date of first entry:	
Client:		Date of last modification:	
		WBG staff doing the first entry:	
		WBG staff responsible of last modification:	
CRITERIA	INDICATOR	RESPONSE	OBSERVATIONS
WBG strategic fit			
Developmental effectiveness potential	Possibility of reform		
Country classification	Post-conflict country/region?		
	IDA country?		
	Frontier country or region of middle-income country?		
Success potential			
Political/institutional environment	Within political/electoral cycle?		
	Good institutional cohesiveness?		
	Good institutional credibility?		
	High-level contact/institution?		
	If department has worked with this client before has previous experience been positive?		
Government commitment	Is government truly committed to the project?		
	Is there a demonstrated path toward reform?		
	Is there a record of reforms already in place?		
Resources			
Resources availability	Is there staff to manage and implement?		
Client/donor funding	Has a source of funding being identified?		
	Is client in agreement to contribute?		
	Is there partnering/co-funding possibilities?		

Presence and support from regional IFC/WB facility	Is there a local presence?		
SCREENING CONCLUSIONS			
	Investment Climate strategic fit		
	Success potential		
	Resources		
	GENERAL CONCLUSION		

APPENDIX 6: LAW ASSESSMENT TOOL

LAW ASSESSMENT FRAMEWORK

	1 (weakest)	2 (moderate)	3 (strong/good practice)	COMMENTS AND ACTION NEEDED
1- CONSIDERATIONS FOR ENTRY OF FOREIGN INVESTMENT				
Sectoral Restrictions	Long negative list or having at the same time positive and negative lists	Negative list with few restrictions such as those related to national security	All the sectors are open to foreign and domestic investors	
Prohibition or Limitation on Foreign Ownership	Foreign investors are not allowed	Foreign investors' ownership of equity is limited to a certain percentage (forcing them into joint venture)	Foreign investors can own equity without any limitation (100%)	
Minimum Investment Requirement	Minimum investment is required for all investments	Minimum investment is required for a limited number of very specific activities	No minimum investment requirement for foreign and domestic investors, normal capital requirement for companies applies	

Screening Approach	Screening is required with unclear and discretionary criteria	Screening is required with (i) clear definition of the responsible governmental entity, (ii) clear and objective criteria , (iii) time limit to take a decision (iv) decision needs to be motivated and (v) investor has an appeal mechanism	Screening is not required, investment is automatic, following normal company registration. Simple notification can take place in the case of FDI, for statistical and monitoring purposes	
Performance Requirements	Performance requirements are provided for		No performance requirements	

2- INVESTOR'S RIGHTS, GUARANTEES AND OBLIGATIONS

Fair and Equitable Treatment	Fair and equitable treatment is not granted	Fair and equitable treatment is partially granted	Fair and equitable treatment is granted to foreign and national investors with a reference to the minimum standard of customary international law, to non-discrimination and to the requirement of due process of law	
National Treatment	National treatment is not granted	Discrimination only for reasons such as: (i) controlling strategic assets in the national interest; (ii) defending national sovereignty in economic matters; (iii) stimulating the development of local industry and (iv) upholding issues of public policy, public health and public morality	National treatment is granted	

MFN Treatment	MFN Treatment is not granted	MFN Treatment is granted with (i) general exceptions such as reasons of public policy, national security, maintenance of public order or public health or (ii) specific exceptions such as taxation, intellectual property, existence of free trade areas, customs unions, regional economic integration organizations (REIO)	MFN Treatment is granted without limitations	
Guarantees against Expropriation	One or all the conditions for expropriation that are listed under “good practice” in the third column are not provided for		Guarantee that the Government will not expropriate except for a public purpose, on a non-discriminatory basis, in accordance with the laws and procedures (“due process”) and subject to the prompt payment of adequate and effective compensation	
Convertibility and Repatriation	No possibility of convertibility and repatriation	Possibility of convertibility and repatriation with constraints such as in time, or formalities	Free and prompt transfer of funds such as profits, dividends, royalties, loan payments and liquidations, in a freely convertible currency of the investor’s choice	

Alternative Dispute Resolution (ADR)	ADR is not allowed under the Law	ADR is allowed with some restrictions such as mandatory negotiations before arbitration and mandatory approval by the State for arbitration proceedings	ADR is fully allowed under the Law, with several options offered to investors (domestic/international arbitration, mediation, etc.)	
Entry of Personnel	Entry of foreign personnel is not allowed	Entry of foreign personnel is restricted for example only to managerial positions	Entry of foreign personnel is fully open, subject to immigration laws and regulations	

APPENDIX 7: DRAFTING GUIDELINES FOR A NEW FOREIGN INVESTMENT LAW¹

Explanatory Note

This document presents drafting guidelines for a new Foreign Investment Act. They were prepared by the Investment Climate Advisory Services (IC) of the World Bank Group (WBG) at the specific request of a client government to provide guidance to the legal drafters in preparing a new legislation on foreign direct investment (FDI).

Preparing new legislation, in any field, is a delicate and complex undertaking requiring thorough analysis of policy objectives, specific economic and institutional circumstances, specific legal issues, and the integration of the new investment legislation in the overall legal framework of the country in question.

These drafting guidelines are no substitute for such a thorough analysis or for expert legal advice. Our hope is that they can be of value to legal drafters in understanding the expectations of investors and the typical content of an investment law. They are not intended to constrain the government's legal drafters in structuring the

proposed legislation in the most appropriate way for their country and government.

General Provisions

1. Preamble. Each country has its own style for the structure of its laws, including how to introduce a new law. If the government decides that a preamble is an appropriate vehicle for the new FDI law, then the drafters should consider stating in the preamble some of the policy choices that underpin the text of the law and stipulating basic principles and rights of investors. A policy statement should not create substantive rights and obligations; however, it can serve as an important promotional tool by describing the country's objectives and policies for

¹ These guidelines were prepared by Xavier Forneris and James Friedlander, respectively IFC staff and consultant.

attracting, facilitating, and safeguarding foreign investment. IC believes that this approach may be particularly relevant in the case where a government is introducing a major departure from the previous legislation applicable to foreign investment.

2. Purpose and Scope. If it is inappropriate for the government drafters to include a preamble to the new FDI law, then IC proposes that the first section of the law should provide a clear formulation of the purpose of the new law. This would include a statement of the objectives that the government has in promulgating the new law.
3. Definitions. The scope of an investment law needs to be clearly defined, usually by including a definition section that sets forth the main terms and concepts used in the law. In addition to defining the agents and parties that the law mentions, definitions of the institutions, committees, and bodies dealing with the implementation of the law also assist the investor to understand the procedures that are involved. It is important to define general terms by reference to international standards. For the sake of convenience, it is better to include all applicable definitions in a separate section of the new FDI law.
 - One of the most important definitions is that of a “foreign investor.” The government will have to consider whether the definition should refer to a “foreign investor” by the investor’s nationality or residence. Does the term “foreign investor” refer only to a foreign national or also to an investor residing abroad regardless of nationality? One factor to take into account in defining “foreign investor” is whether the government wishes to attract investment from its own nationals living abroad.
 - It is common in an FDI law to

distinguish between a “resident” and a “nonresident,” mainly to address the issue of whether the investor is entitled to repatriate profits and capital. In using the definitions of “resident” and “nonresident,” foreign investment laws frequently refer to the definitions of these terms that are found in the country’s foreign exchange law. It is international best practice to define “nonresident” in a broad, all-encompassing way, not subject to any significant limitations.

- Another important definition is the distinction between “direct investment” and “other investment.” An FDI law is aimed primarily at “direct investment,” which is long-term investment in plant and equipment that is accompanied by some measure of effective management control by the foreign investor. The term “other investment” involves financial flows that have a higher degree of liquidity (frequently referred to as “portfolio investment”) and that do not involve any management control by the foreign investor.
- If the government decides that for national security or other reasons not all sectors will be open to foreign investment, then a definition of “eligible investments” or “eligible sectors” can be used to limit the investments or sectors that a foreign investor can make, although this can be better addressed in a “negative list”. Another definition that can be used is a reference to the type of goods invested so as to ascertain the rights of the foreign investor to transfer income derived from the sale of the goods so invested.
- Perhaps one of the most important definitions is that of “freely convertible currency,” which is usually tied to those

currencies defined as such by the International Monetary Fund. For the foreign investor, it is most important to ensure that profits and capital gains in local currency can be converted without restriction into “freely convertible currency.”

FDI Entry Process

4. Freedom to Invest and Sectoral Restrictions. Each country approaches the introduction of sectoral restrictions in its own way. Some countries have no restrictions at all. Others have only limited restrictions on the sectors of the economy in which FDI is allowed. Other countries impose a variety of entry restrictions on foreign investors, often permitting foreign investors to be involved in these sectors only under special conditions or licensing arrangements.
5. The worldwide trend of the past decade is for countries to allow foreign investment in all sectors. However, if there is a desire to limit FDI in certain areas, this can best be done by defining closed or restricted areas on a “negative” or “restricted” list. While the government may have legitimate reasons to restrict FDI, any such restrictions or limitations will have an obvious impact on the overall inflow of FDI.
6. When a country imposes restrictions or limitations, these are usually applied to entire sectors, not to the size of an investment, the technology used, or any limitations on foreign ownership. Otherwise, the results are often not the ones intended and at times may even be counterproductive. In certain restricted sectors, there may be ownership restrictions (for example, minority ownership in media) that are intended to protect national interests.
7. The negative list approach is used by some countries to administer the restrictions on entry. To be effective and reasonably acceptable to foreign investors, the negative list is short and nondiscretionary. The administration of the negative list should have the following characteristics: (i) an inter-agency/ministry governmental organization is responsible for approval for investments that fall into the negative list; (ii) the organization itself should make the decision; (iii) the organization’s criteria and procedures should be well established and transparent; (iv) the decision should be made within stated time periods; (v) any submission for decision should include a reasonable amount of supporting documentation; (vi) if the application is rejected, the organization should give reasons for its decision. An appeal mechanism to a higher governmental body should be part of the process.
8. Registration. In most countries, registration is the subject of local company law. The purpose of registration is to provide basic information to the authorities about the investment. Such information normally includes a description of the project, an appropriate industrial classification, its expected size in terms of financial and capital assets, the identification of the nationality of its ownership and the address of the registered office. This information is needed for statistical reasons, tax administration, and effective and sensible monitoring. Registration should not be utilized as a screening mechanism for foreign investment but is a formality that all businesses, foreign and local, have to go through in order to be recognized as a legal entity and legally operate in the country.
9. Many countries maintain a laborious and inefficient registration process for the establishment of a company (as identified in IC Administrative Barriers to Investment country reports and the World Bank’s Doing

Business research project). It is not unusual to see countries where investors have to complete more than 20 procedures to establish a company. Many of these procedures are repetitive and nonessential. A better registration process is one that is simple, short, inexpensive, accessible, and, most importantly, not a screening or approval process, either directly or in disguise. Only limited information that is relevant and purposeful is requested from the registrant. As an example, the registration process should not require the foreign investor to present business plans, feasibility studies, or other strategic and operational documentation relevant to the business of the foreign investor.

Guarantees to Foreign Investors²

10. National Treatment and Most Favored Nation (MFN). This policy of non-discrimination among investors should be enshrined in the new FDI law. There is no general rule of international law that obliges a host nation to protect the investments made by an investor from a foreign jurisdiction. For this reason, it has become international best practice that the laws of the host nation acknowledge the principle of nondiscrimination against or between foreign investors.
11. Nevertheless, it should be acknowledged that many host nations discriminate to some extent for reasons such as: (i) controlling strategic assets in the national interest; (ii) defending national sovereignty in economic

² This section could also be entitled “Rights and Obligations of Foreign Investors.” While foreign investors all realize that they are subject to the laws of the country of investment, they will see the wording “obligations of foreign investors” as less onerous than the wording of competitive foreign investment laws.

matters; (iii) stimulating the development of local industry; and (iv) upholding issues of public policy and public morality.

12. Guarantee of Convertibility into Freely Convertible Currency. Access to foreign exchange is generally important for all businesses to enable them to meet the costs of imports and other foreign obligations, such as management/royalty/license fees, foreign travel, expatriate costs, and debt service obligations. For the foreign investor, access to foreign exchange is essential, as the investor operates in at least two different economies involving not fewer than two currencies. No serious foreign investor would consider investing in a country unless the investor feels confident that foreign exchange is available and accessible, not only for the daily operations of the business enterprise, but also to meet debt service obligations and to repatriate profits and capital.
13. The right to convert local currency into freely convertible currency, as defined in the law, should be guaranteed to the foreign investor. This right should not be restricted by the form of investment that the investor has made in the host country, nor should it be restricted by the purpose of the conversion. The foreign investor may have to meet certain conditions to make these transfers (such as payment of taxes before profits are remitted), but there should be no other restrictions on these transfers.
14. Guarantee of No Expropriation or Nationalization Without Compensation. Foreign investors decide to invest abroad based on the commercial strategy of the investor, the host country’s economic environment, and the risks affecting the projected rate of return on the proposed investment. Foreign investors will take steps to insure against all of these foreseeable risks.

15. High levels of risk relating to the activities of the host government, such as interference, overregulation or expropriation, will either deter private investors or cause them to demand higher-than-normal rates of return in compensation. To attract FDI and to reduce its costs, host governments that seek to attract foreign capital need to take steps to reduce such political risks. Expropriation of assets, regardless of the characterization of these assets as immovable or movable, tangible or intangible, is perceived as one of the main political risks for foreign investors. While direct, explicit expropriations are uncommon these days, expropriation by “degrees” or “stages” does happen; this is a very serious risk for project developers (usually for large infrastructure projects) and foreign capital in general. Customary principles of international law require that when foreign properties are expropriated, the reason for doing so should be the public good, the relevant action should be nondiscriminatory, and compensation (termed to be prompt, effective, and adequate) must be paid to foreign owners that have had their assets expropriated. World Bank guidelines conform to these customary principles of international law.
16. The first level of protection for a foreign investor against any risk of expropriation is found within the legislation of the host country, starting with the Constitution. Project developers of major infrastructure projects often require the host government to give a long-term commitment against expropriation. Where there is unpredictability in the political conduct of a government, such as sudden changes to the foreign investment policy or expropriation of foreign-owned assets, either directly or by “creeping expropriation,” the number of willing investors and the flow of capital into a country will surely diminish.
17. The next level of protection against the risk of expropriation is found in bilateral and international treaties. Foreign investors and their lenders can often obtain political risk insurance through national, regional, bilateral and multilateral investment guarantee programs and from private insurers against noncommercial risks. To the extent that the situation in a country requires the foreign investor to obtain this coverage, the cost of this insurance is another burden that the foreign investor must finance.
18. International best practice permits a country to expropriate or nationalize foreign-owned assets under certain conditions, that is, when the action is for public purposes, when the procedures are open and transparent and when the action is nondiscriminatory in nature. In such cases, international best practice requires that prompt, effective, and adequate compensation be paid. When the country’s legal framework does not include such international standard, this guarantee needs to be stated clearly in the new FDI law.
19. Access to Land, Labor and Expatriate Personnel. An FDI law is a useful investment promotion tool. It need not repeat the substance of all other laws that are of interest to foreign investors. In certain cases, however, an FDI law can effectively reinforce protections given to foreign investors by re-stating briefly the rights to which foreign investors are entitled in other applicable legislation. Some of the common issues that affect all foreign investors are: (i) land ownership or rights to use land, (ii) freedom to employ expatriates, (iii) access to labor permits and visas, (iv) ability to transfer overseas some portion of expatriate wages that are paid locally, (v) granting of all required licenses, and (vi) freedom to choose suppliers.
20. An FDI law modeled on international best practice should confirm that such licenses,

permits, and concessions as are necessary for the uninterrupted operation of the foreign investment are issued by the appropriate authority. In addition, specific mention should be made of the freedom of the foreign investor to employ key managers regardless of their nationality.

21. Equally important to re-emphasize in the new FDI law is a foreign investor's right to own land or use land. One way in which to guarantee these rights to a foreign investor is to refer to other specific legislation. Another way is to state in the FDI law that the foreign investor has the same rights to own or use land as a domestic investor, thereby re-enforcing the concept of nondiscrimination by nationality.
22. Investment Incentives. IC always recommends against incentives available only to foreign investors and incentives such as tax holidays. International best practice indicates that fiscal incentives, if any, should be set forth in the tax legislation and implemented by the tax administration; customs incentives should be set forth in the customs legislation and implemented by the customs administration; similarly investment incentives in areas such as labor, immigration, public procurement, land, credit, and intellectual property should be set forth and administered according to the laws on those issues. While IC is not advocating for the above or any other investment incentives, we are saying that if there are incentives, the most appropriate way to handle them is through the relevant legislation applicable to everyone in the country. If the government wants to apply international best practice, the new FDI law should not provide any investment incentive and the investment promotion intermediary (IPI) (when it exists) should no longer be involved in issuing investment incentives. Any incentive should be administered and granted by the relevant government agency in accordance with the relevant legislation. This principle also holds for special economic zones laws with respect to incentives.
23. While investment incentives should not be granted in the new FDI law, it is not uncommon for the law to refer to them. The new law can restate that local and foreign investors are eligible to the same incentives and are equally treated. In our opinion, nothing prevents the new FDI law from making a reference to existing laws in which fiscal and other incentives are set forth, for promotional and informational purposes.
24. Investment Promotion Intermediary. These drafting guidelines are not the place to have a detailed discussion on the usefulness of investment promotion activities and the necessity for an IPI. However, we need to address the potential use of the new FDI law to establish the IPI or to make a reference to an existing IPI.
25. Should the host country decide to establish an IPI to carry out investment promotion functions, the new FDI law is one platform from which to establish this unit. Alternatively, the host country's legal system may provide other effective vehicles to do so. If after careful consideration of this issue the government and other stakeholders decide that the new FDI law is the appropriate vehicle, then the mission, objectives, and governance of the IPI could be delineated in a brief and effective manner in this law. In this case, the FDI law would leave the details of the IPI's operations to be governed by regulations issued by the appropriate governmental authority. This would allow the new FDI law to become one of the main promotional tools for the promotion of foreign investment in the host country.

Settlement of Investment Disputes

26. **Dispute Resolution.** It is international best practice for parties to a commercial agreement to ensure that they will receive what has been contracted for through an effective system of dispute resolution that will enforce the terms of the contract. Good dispute resolution procedures are fundamental to ensuring that the risks accepted by each party to a commercial agreement are, in fact, the economic risks borne by each party.
27. Although most countries have highly developed legal systems, foreign investors tend to be wary of settling disputes or seeking to enforce their contractual rights in local courts. This is because local legal procedures may be unfamiliar to them, and they do not understand the language spoken in front of a tribunal that they suspect may be inherently hostile to their interests at best, and influenced in other ways at worst.
28. Because of these local uncertainties, most foreign investment laws provide for dispute resolution by international arbitration. The aim of international arbitration is to provide the parties with a certain and transparent method of resolving investment disputes in a neutral forum. There are now global standards on international arbitration, whether conducted through the rules and procedures of institutions such as the International Centre for Settlement of Investment Disputes (ICSID), the International Chamber of Commerce (ICC), or the United Nations Commission for International Trade Law (UNCITRAL). In many cases, international arbitration is the only method by which an investor can be sure that it will be able to enforce its rights against the government or against its co-investors.
29. While it is international best practice to use “international” arbitration, this need not be

the case in all instances. Good rules for domestic arbitration upheld by clear and properly enforced laws can provide local businesses with a strong argument for resisting foreign investors’ demands for international arbitration in a neutral forum. For example, the 1996 Arbitration Law in India was enacted with precisely this aim in mind by following the UNCITRAL Model Law. In addition, India is a signatory to the New York Convention.² But once the principle has been established of accepting arbitration as creating enforceable legal remedies without reference to domestic courts, there is little purpose in depriving contracting commercial parties of the opportunity to select a place of arbitration outside the host state should they choose freely to do so.

Transitional Provisions

30. **Repeal of the existing FDI Law.** To bring the new FDI law into force, a series of issues need to be addressed. First, the existing FDI law must be repealed in its entirety. This means not only the repeal of the law but also of all regulations issued under the law. While this may seem relatively easy to accomplish, care must be taken to ensure that there are no

² Under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958), courts of a signatory state are required to enforce (subject to limited exceptions) an arbitral award that has been rendered within the territory of any other state that has also signed the convention. The nationality of the parties is immaterial—it is the “nationality” of the award that counts. Choosing to arbitrate a dispute in a state that has ratified the Convention, therefore, presents significant advantages because any award rendered in that state will be enforceable in any other state that has signed the convention.

other laws that will be directly affected by the repeal of the existing law, and if there are any, then these laws must be changed appropriately.

31. Equally important to the effective repeal of the existing FDI law and the regulations issued thereunder is the requirement to protect any investment incentives that have been granted under that law. The so-called “grandfathering” of incentives already granted to investors is not only in conformity with international best practice, it is a fundamental right in any legal system. Thus, investors will treat incentives granted under applicable law as inviolable. Any attempt, whether intentional or not, to divest an investor of a granted incentive will be strongly resisted by the affected investor in particular and by the investment community in general. Because existing investors in any country are among the most important tools for the promotion of new investment, it

would be foolhardy to take away any incentives that had been properly granted under existing law. This would become a strong disincentive for prospective investors.

32. To ensure that there is no lacuna in the law, at the same time that the existing FDI law is repealed, the new FDI law must enter into effect. Investors fall into three categories, and each must be catered to at the same time. First, existing investors cannot lose incentives that have already been granted, although the existing FDI law and related regulations are repealed. Second, active prospective investors that have already spent time in the host country determining whether to invest will need to understand how they will be affected by the new FDI law. Lastly, prospective investors that have not yet visited the country and have not yet decided to invest in the country will, once their interest turns to the host country, watch carefully how the new FDI law has dealt with both of the other classes of investors.

APPENDIX 8: CHECKLIST OF ISSUES THAT A NEW FDI LAW SHOULD ADDRESS¹

Based on our direct work experience on Foreign Direct Investment (FDI) law reform in developing/transition economies, we have prepared a checklist of what a good FDI law might include.

We have been perhaps more inclusive than required, to stimulate discussion within the Investment Climate Advisory Services (IC) of the World Bank Group (WBG) before finalizing the checklist. Of course, the actual content will depend on many factors, the specific country circumstances, and in particular the degree of respect for the rule of law in the country in question, quality and actual enforcement of the legal framework, and so forth.

This checklist is for the IC and other World Bank Group staff who have to advise client countries on investment law reform.

This checklist cannot be seen or should be used as a substitute for expert legal advice. In this field as in many others, thorough situation analysis remains indispensable before any advice can be

offered in any meaningful way.

1. Preamble

- a. Statement of government's policy objectives
- b. Statement of basic principles

2. Definitions

Clarify application of law by use of definitions

- a. "Foreign" vs. "Domestic" investor/investment
- b. "Resident" vs. "non-resident"
- c. "Direct" vs. "Portfolio" investment
- d. "Freely convertible currency"
- e. Others

3. Entry process

¹ This Checklist was prepared by Xavier Forneris and James Friedlander, respectively IFC staff and consultant.

- a. Registration
 - i. In many countries, covered by company law
 - ii. Information-gathering for statistical purposes
 - iii. Lack of screening; true registration
- b. Sectoral restrictions
 - i. Are sectoral restrictions necessary?
 - ii. If so, what should be on the “Negative list”

4. Guarantees to foreign investors

- a. National treatment/FET/MFN
 - i. Non-discrimination between domestic and foreign (or resident/nonresident)
 - ii. Nondiscrimination between foreign investors
- b. Guarantee of convertibility of local currency into freely convertible currency and guarantee of profit/capital repatriation
- c. Guarantees against expropriation/nationalization
 - i. Likely repetition of Constitution and any other laws
 - ii. Use of expected international legal standard of “fair, prompt, effective and adequate compensation”
- d. Access to land, labor, expatriate personnel
 - i. Summary of entitlements, based on other laws and regulations
 - ii. No need to create something new
- e. Stabilization of laws

- i. “Grandfathering” usually in certain sectors (such as oil and gas, and mining)
- ii. “Grandfathering” of existing incentives covered in “Transitional” section below

5. Incentives

- a. Reference to incentives that exist in other legislation
- b. Such areas as taxation, customs, and similar fiscal incentives

6. Investment promotion intermediary (IPI) (optional, but many countries use the new investment legislation to establish the IPI or equivalent body and provide its structure/mandate, but leave details to the implementing regulation)

- a. Establishment
- b. Structure
- c. Powers
- d. Right to issue regulations

7. Dispute resolution

- a. Local arbitration/courts permissible if parties agree
- b. International arbitration
- c. High visibility/priority for any foreign investor

8. Transitional and final provisions

- a. Repeal of previous/current law and applicable regulations
- b. “Grandfathering” of investors with existing incentives until period of incentives is completed
- c. Entry into effect



APPENDIX 9: PRE-FIELD AND FIELD ASSESSMENT

INVESTMENT POLICY

Link to Investing Across Borders Indicators country results and/or link to bottom of tab with a copy & paste of main indicators.

Link to Doing Business (DB) rankings and/or link to bottom of tab with a copy & paste of main DB indicators with regional comparison.

Is there an investment law and/or investment policy statement?

Which of the following rights does the client country guarantee in its investment law?

Fair and equitable treatment

National treatment Most

Most Favoured Nation Treatment

Currency convertibility and repatriation

Access to land

Expropriation

Arbitration

Which restrictions does the client country have in its investment law?

Sectoral restrictions

Limitations on foreign ownership

Authorization and screening

Minimum investment requirement

Performance requirement

A. Does the investment law or other legislation provide any incentives?

B. Are these incentives sector-specific?

Are investment laws and policies easily accessible?

Do service providers such as lawyers, accountants, and real estate agents have a clear understanding of the investment laws and regulations?

Does the government engage local and foreign stakeholders in their policy and regulatory reform processes?

Is there a law mandating the establishment of a specific institution or department responsible for investment promotion?

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