

*The Origins of NAFTA Investment
Provisions:
Economic and Policy Considerations*

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Introduction

This paper will provide some of the background to Canada's current international investment policy regime. For almost twenty years, and particularly during the past ten, the evolution of this regime has increasingly focused on the negotiation and support of a framework through which international investment flows from abroad, and more recently from Canada, may be facilitated. The most expeditious and practical way in which this framework can be enshrined is through the negotiation of investment rules with our trading partners.

Some of this material, both statistical and conceptual, may be familiar to the reader, but it is nonetheless important to review some of the debate over international investment rules in a broader perspective with respect to developments both in Canada and abroad. This paper will also develop the context for the other papers in this volume, setting the stage for more productive debate over the more polemical issues associated with NAFTA chapter 11.

This paper begins by documenting the growth in flows of foreign direct investment (FDI), both in Canada and abroad. These are compared with both international trade and economic growth data. It is observed that the trends in FDI growth have tended to manifest themselves before the formulation of a policy response. Nonetheless the resulting response has been fundamental to the consolidation of these trends as the appreciation of the benefits of FDI has increased and the complementarities between trade and investment flows in the modern economy better realised. Notably, this policy response has been at both

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the domestic and international level, as international organisations have also sought to provide a complementary counterpart to the network of bilateral and regional agreements that have proliferated over the past twenty years.²

Canadian experience has epitomized all these trends as the growth of FDI – and particularly Canadian Direct Investment Abroad (CDIA) – have become increasingly important to the Canadian economy. Institutionally, Canada began by unilaterally liberalising its international investment regime, and consolidated this in a series of international agreements – first in the Canada-US Free Trade Agreement (FTA), then in a number of bilateral agreements, mostly with developing countries, in the North American Free Trade Agreement (NAFTA), more recently multilateral in the General Agreement on Trade and Services (GATS) (which contains important investment provisions) and in other agreements that continue to be championed and negotiated. This is not to say that this has been a smooth path: international investment rules, if not a phenomenon of FDI itself, continue to be controversial amongst an influential group of critics, but the Canadian government has sought to respond to these criticisms in a number of ways.

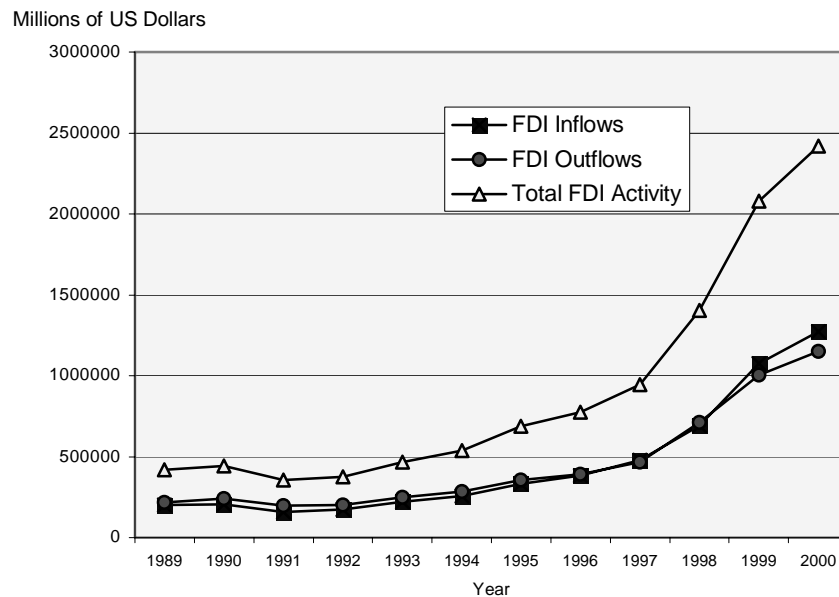
But it is the NAFTA investment provisions that embody some of the most innovative provisions dealing with investment flows – particularly in an agreement that includes developed and developing countries. While they are innovative, however, an examination of their antecedents reveals that they represent a logical step in the evolution of an international regime for increasingly complementary trade (including trade in services) and FDI flows. This paper will describe the most important of these provisions, but first it will address the policy context behind them.

Recent Growth in FDI

No discussion dealing with foreign investment rules can avoid summarising the recent growth in FDI flows. For global flows, UNCTAD is the most often quoted source of data, and in September of 2001 it announced that FDI inflows amounted to over US\$1 trillion in 2000 (UNCTAD WIR, 2001; see Chart 1). What is most remarkable about this figure is the fact that it had more than tripled from a level of US\$315 billion in 1995, which in turn had increased by a factor of twelve since reaching US\$25 billion in 1973 (WTO, 1996).³ Global inflows closely mirror outflows; this is echoed in Canadian data (see Chart 4).

² There remains a gap at the multilateral level – TRIMs, GATS and other investment related provisions in WTO agreements notwithstanding – but the recent WTO Ministerial Doha Declaration lays the groundwork for resolution.

³ The increase of FDI in developing countries is even more marked, rising from US\$2.2 billion in 1970 to \$154 billion in 1997 (see John Williamson, “Globalization: The Concept, Causes and Consequences”, Keynote address to the Congress of the Sri Lankan Association for the Advancement of Science, Colombo, 15 December 1998.)

Chart 1 Global FDI Flows

Source: UNCTAD, *World Investment Report*, various issues.

The vast majority of this FDI originated in OECD countries, although the proportion of FDI outflows from developing countries had increased from under 5% in the early 1970s to 18% in 2000 (albeit highly concentrated in a few economies, such as China, Hong Kong, and Brazil). Another noteworthy aspect of this trend is that much of this increase is accounted for by increased merger and acquisition (M&A) activity, particularly in the developed world. M&As are sometimes seen as another means of obtaining access to markets and diversification by globalizing firms; this phenomenon too can bring benefits to the host economy as long as competition and other policies can reinforce complementary market and regulatory mechanisms.

This exponential growth in FDI has often been cited as epitomizing globalization. FDI flows represent an increasingly important but nonetheless relatively small proportion of global GDP.⁴ In the most recent *World Investment Report*, UNCTAD noted that in accounting for the share of inward FDI stock in

⁴ It represents an even tinier proportion of capital transactions in foreign exchange markets, which reached US\$1.3 trillion per day by the end of the 1990s, of which less than 2% is directly attributable to trade transactions.

terms of GDP, only 6 countries (Belgium/Luxembourg, Angola, Lesotho, Hong Kong China, Azerbaijan, and Ireland) had more than a five percent share. Canada ranked 30th at 1.8%, behind other outward oriented OECD economies including Sweden, the Netherlands, the UK, and Denmark (see Table 1).

Although these proportions have increased throughout the 1990s, it is evident that FDI, while an important supplement to domestic sources of capital, represents a relatively small proportion of all countries' investment capital, including Canada's.

Table 1 *Share of GDP Accounted for by Stock of FDI Inflows (Percent)*

Rank	Economy	1998-2000	Rank	Economy	1998-2000
1	Belgium & Luxembourg	8.5	26	United Kingdom	2.0
2	Angola	7.7	27	Bulgaria	1.9
3	Lesotho	7.4	28	Mozambique	1.9
4	Hong Kong, China	6.3	29	Denmark	1.9
5	Azerbaijan	5.6	30	Canada	1.8
6	Ireland	5.1	31	Dominican Republic	1.8
7	Malta	4.5	32	Moldova, Republic of	1.8
8	Sweden	4.4	33	Zambia	1.7
9	Netherlands	3.5	34	Lithuania	1.7
10	Seychelles	3.1	35	Latvia	1.7
11	Bolivia	3.1	36	Papua New Guinea	1.6
12	Trinidad & Tobago	3.0	37	Croatia	1.6
13	Nicaragua	2.9	38	Malaysia	1.6
14	Czech Republic	2.7	39	Poland	1.5
15	Swaziland	2.7	40	Slovakia	1.5
16	Armenia	2.6	41	Costa Rica	1.5
17	Estonia	2.5	42	Argentina	1.3
18	Chile	2.4	43	Cambodia	1.3
19	Panama	2.3	44	China	1.3
20	Singapore	2.2	45	Germany	1.2
21	Jamaica	2.2	46	Brazil	1.2
22	Guyana	2.2	47	Hungary	1.2
23	Bahrain	2.1	48	Venezuela	1.2
24	Kazakhstan	2.1	49	El Salvador	1.2
25	Finland	2.0	50	Switzerland	1.1

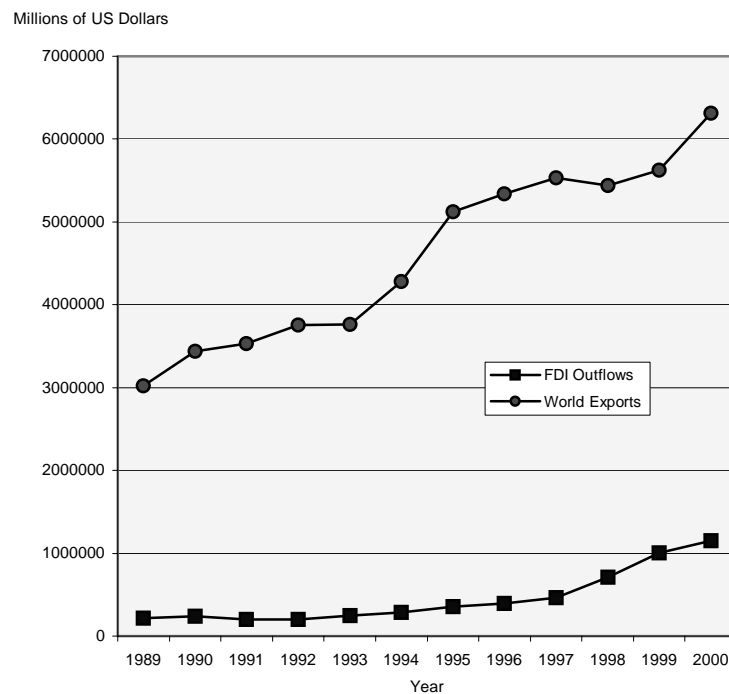
Source: UNCTAD, *World Investment Report*, 2001.

Finally, while it is true that FDI flows have been increasing at a greater rate than trade flows, FDI flows are still smaller than trade flows (see Chart 2). This in itself is not significant; the point here is that international trade and investment policies have increasingly had to respond to firm activity that uses both investment and trade as a means to achieve profit and market share. With local affiliate sales now just as important as traditional exports (if not more),

market access for MNEs has become the central negotiating issue in international trade relations.

In sum, although international investment represents important and growing potential economic growth, it *alone* is not as pervasive as some critics – and supporters – suggest. However the “profile” of FDI in host economies is often high; part of this influence is due to the fact that its effects are manifested more obviously than that of trade in goods and services. Unlike trade, which is traditionally regulated at the international frontier of the state, international investment takes place at the heart of the legal and regulatory environment.

Chart 2 World FDI Outflows & Exports



Source: UNCTAD, *World Investment Report*, various issues; and International Monetary Fund, *International Financial Statistics*, various issues.

This phenomenon is perhaps the key example of what has been called “deeper integration”, whereby recent international economic trends – including the growth in importance of FDI – have made it more difficult for countries to pursue discriminatory (or isolationist) economic policies without adversely affecting their economic prospects. Even so, concerns linked to this have led Canada, the United States, and a growing number of countries to insist in every international investment forum that governments retain the “right to regulate” in

the public interest on a non-discriminatory basis, and that no agreement supplants this sovereign right.

The Benefits of FDI Revisited

Nothing illustrates the desirability of FDI more than increased competition for it, which is evident in both developed and developing countries. Nonetheless, although the real benefits of FDI are increasingly appreciated, criticism of FDI has sometimes focused at allegedly negative financial characteristics. For instance during the Asian financial crisis FDI was likened to other capital flows as skittish and all too ready to exit fragile economies at times of crisis, thereby exacerbating economic problems when host countries can least afford it.

It is worth briefly reviewing some of these allegations. All capital is fungible to a greater or lesser degree. But FDI flows represent cross-border financing of 10% or more of the assets of a host country entity. And as financial crises in a number of countries in the late 1990s made apparent, FDI was amongst the most stable of capital flows (Lipse, 2001). Indeed it is precisely because it is differentiated from other more liquid assets, i.e. invested in tangible assets with long term returns in mind, that it cannot react as quickly as other capital assets, domestic or foreign. In turn, this also explains why investment protection provisions have long been recognized as a key element in foreign investment treaties: in essence, in order to recognize the long term commitment FDI represents.

A fundamental reason FDI is deemed desirable is because it sometimes supplements domestic savings in comprising available investment capital. But FDI does not necessarily represent *additional* capital to the domestic capital stock since it may be financed in the host market.⁵ Nonetheless, this is not necessarily problematic. Indeed FDI is increasingly and aggressively courted for its non-financial benefits, including technological know-how, marketing and other management practices, the demonstration effect vis-à-vis efficiencies picked up by domestic firms, linkages to regional or international markets, as well as other spillovers –employment opportunities not least among them.

Another recent criticism suggests that FDI “crowds out” domestic investment. But “crowding out” of domestic investment does not necessarily occur when FDI takes place, and if it does, it is not necessarily a negative development. After all, efficient domestic investment can also “crowd out” other inefficient investment (new or existing), particularly if it involves investment on a very large scale compared with the size of the domestic market. Indeed the very concept of “crowding out” seeks to characterize as problematic

⁵ This has long been recognized. Indeed Jean-Jacques Servan Schreiber, in *Le défi américain*, complained of this phenomenon in the 1960s: “C’est ainsi qu’à concurrence des neuf dixièmes, les investissements américains réalisés en Europe sont financés au moyen de ressources européennes. Nous les payons, en quelque sorte, pour qu’ils nous achètent.” (emphasis in original)

precisely those aspects of FDI that are hotly pursued, particularly management skills, technological know-how, job opportunities, and other invigorating effects. Again, this is true even if FDI is financed entirely in the host market.

In fact an increased recognition of the benefits of FDI in spite of the ostensible drawbacks associated with it has led to increased competition for FDI through a plethora of investment promotion and incentives programmes around the world – which are themselves criticized for distorting the markets for FDI. It is true that the capacity of an economy to glean the benefits of FDI is enhanced when domestic legal, regulatory, and economic capacities are strong. But it could also be argued that the potential income generated through investment, whether domestic or foreign, can ultimately help in building these capacities.

Thus it is not only for institutional reasons that governments have sought to negotiate international investment rules. It is also believed that reducing barriers to investment flows is in the long term interest of domestic constituents, and that the stability embodied in legal norms is the best way to facilitate this. Indeed investment rules are only one way of encouraging FDI, and governments continue with these efforts, even as criticism of the benefits of FDI continues.

Business groups generally support moves to negotiate international investment rules, although their lobbying efforts continue to be directed towards traditional trading goals (such as tariff reduction and other measures affecting trade in goods) rather than investment barriers - perhaps reflecting the still greater importance of trade flows. It is also true that business in protected sectors may view investment liberalization as a threat since it may bring increased competition.

Indeed perhaps reflecting sensitivity to the public debate, business voices have been relatively muted with respect to international investment – this was certainly true during the MAI negotiations. Nonetheless, business continues to experience real barriers to investment, which are costly and time consuming to address. Two recent comprehensive studies are revealing in this regard, one of Canadian businesses sponsored by Industry Canada (Canadian Chamber of Commerce, 2000) and another commissioned by the European Commission (European Commission, 2000), whose purpose was also to gauge support for international investment rules.

The Policy Response to Changes in FDI Patterns

The policy response to these changes has been multifaceted, taking place at the local, regional, national, and international level, and has manifested itself with respect to traditional institutional responses, often complemented at the regulatory level as well. Notably, policies at the international level have reflected those at the national level, usually with a lag. Nonetheless it is useful to review these international developments over the past twenty years in order to put some of the policy responses in a broader context.

The sample of recent FDI and other trends captured in the previous section provide the background to the institutional response by governments, including Canada. At the outset, it is important to note that international investment policy has often been formulated in *response* to changes already in evidence. Sylvia Ostry, one of Canada's most perspicacious observers of international economic developments, describes this tendency as a "rear-view mirror approach" to international investment policy making (Ostry, 1997).

A precursor to some of these policy changes lay in the Canadian response to "the FIRA⁶ case", whereby under GATT rules the US requested that a Panel be established in 1982 to consider FIRA administration relating to stipulations concerning domestic purchasing requirements and export undertakings (Paterson et. al, 1986). Both Canada and the US agreed that neither the legitimacy of FIRA measures, nor the regulation of FDI, were under consideration by the GATT panel. Rather, the panel considered whether undertakings under these stipulations (i.e. performance requirements) were consistent with the provisions of the GATT. The GATT panel called into question some of FIRA's purchasing and export requirements, and Canada committed itself to changing its practices. It was plain, however, that artificial divisions between international trade and investment policy would no longer enjoy protection under international rules. Given these developments (which again increasingly reflected economic realities and the evolution of business practices), Canada quickly came to realise that it would be prudent to advocate rules under which international investment relations could thrive. This manifested itself first in its relations with the United States, its most important trade and investment partner, as well as with respect to the negotiation of the Agreement on Trade-Related Investment Measures (TRIMs) as part of the Uruguay Round to the WTO.

The Canada-US Free Trade Agreement (FTA)

As a harbinger of things to come, the Canada-US Free Trade Agreement contained an investment chapter (chapter 16) when it was negotiated in 1987. Although limited, it embodied concepts fundamental to international investment agreements, and included articles on national treatment (1602), performance requirements (1603), expropriation (1605), and transfers (1606).⁷ The article on performance requirements was relatively circumscribed in comparison with the NAFTA, but not in comparison with the yet to be negotiated TRIMs agreement. It applied only to investors from signatory countries, and did not include prohibitions on performance requirements conditioned upon the receipt of "an advantage" (i.e. including subsidies).

⁶ Foreign Investment Review Act/Agency (FIRA).

⁷ In turn, key provisions in international investment agreements were based on longstanding fundamental provisions in international trade, including in particular the principal of non-discrimination upon which all trade agreements were anchored.

There was also an article dealing with disputes (1608), which acknowledged the “special nature of investment disputes and the expertise required to resolve them” and, in view of this fact, recommended arbitration or “panel procedures” as outlined in Articles 1806 or 1807 of specific institutional provisions for the settlement of disputes. There were a number of other limitations to FTA coverage: the FTA investment provisions applied only to for-profit business enterprises, and investment controlled by Canadians or Americans.

The FTA was also a more self-contained agreement, in that it contained no most-favoured nation (MFN) provisions, nor articles on minimum standard of treatment. In addition, FTA investment provisions applied only to future measures, ie. prevailing laws, policies, and practices were “grandfathered”, including sectoral restrictions – among them the politically sensitive cultural industries sector – and the newly amended Investment Canada Act.

There were no provisions for investor-state dispute settlement, however, which would figure so prominently in Chapter 11 of the NAFTA. Nonetheless the stage had been set for the further anchoring of investment protection and other provisions that were subsequently included in the NAFTA. In fact it could be argued that the replacement of FIRA by Investment Canada was more significant than the change from the FTA to NAFTA. The former represented a fundamental shift in policy; the second, while important, was another step in a political trend established with the FTA.

Importantly, these trends were beginning to be echoed elsewhere: Canada had adhered to all OECD investment instruments by the 1980s,⁸ and Canada began to negotiate bilateral investment agreements as well – known as FIPAs (Foreign Investment Agreements); elsewhere as BITs (Bilateral Investment Treaties). The sorts of provisions negotiated in the NAFTA also had echoes in other agreements, including the GATS, APEC’s non-binding investment principles, and the ill-fated Multilateral Agreement on Investment (MAI).

Early Canadian FIPAs and Other International Initiatives

Although it may be tempting to view the NAFTA as representing a radical new departure from prevailing practice with respect to investment protection, it may be more accurately viewed as capturing the evolution of domestic investment liberalisation. Notably, little legal tinkering was required in the investment policy domain in order to ratify the agreement.

Indeed Canada’s willingness to negotiate FIPAs following the successful negotiation of the FTA may be seen also as the manifestation of a desire to consolidate the gains in that agreement, as well as paving the way for future international investment provisions in international agreements advocated

⁸ OECD Declaration on International Investment and Multinational Enterprises (the “Declaration”), and also two OECD Codes of Liberalisation (Code of Liberalisation of Capital Movements and Code of Liberalisation in Invisible Operations)

by Canada. Some observers noted the significance of these FIPAs in the early 1990s as representing a change to longstanding Canadian investment policy, particularly since Canada began to use the more comprehensive NAFTA provisions as its model (see Table 2). What was less remarked upon, however, was that in fact this was a continuation of a process that had begun the previous decade, and secondly it echoed transformations in international investment policy regimes throughout the world.

Table 2 *Canada's Foreign Investment Protection Agreements (FIPAs)*

Agreements Based on Old Model (OECD Based)

Poland	Nov 22/90
USSR*	Jun 27/91
Czech and Slovak Federal Republic**	Mar 9/92
Argentina	Apr 29/93
Hungary	Nov 21/93

Agreements Based on New Model (NAFTA based)

Ukraine	Jul 24/95
Latvia	Jul 27/95
Trinidad and Tobago	Jul 8/96
Philippines	Nov 13/96
Barbados	Jan 17/97
Romania	Feb 11/97
Ecuador	Jun 6/97
Egypt	Nov 3/97
Venezuela	Jan 28/98
Panama	Feb 13/98
Thailand	Sep 24/98
Armenia	May 29/99
Uruguay	Jun 2/99
Lebanon	Jun 19/99
Costa Rica	Sept 29/99
Croatia	Jan 30/01

FIPAs Signed But Not Yet in Force

South Africa	Nov 27/95
El Salvador	May 31/99

* Further to the dissolution of the USSR, the FIPA now binds Russia as the continuing State.

** Further to the dissolution of Czech and Slovak Federal Republic, the FIPA currently binds both the Czech Republic and the Slovak Republic, and is considered as two Agreements.

Source: <http://www.dfait-maeci.gc.ca/tna-nac/fipa-e.asp>. Complete texts of these FIPAs are also available through this DFAIT website.

Growth in bilateral investment treaties may be observed beyond North America and this proliferation is illustrative of widespread trends in these types

of agreements. Elements of what have come to be familiar as core provisions in bilateral investment treaties (non-discrimination, investment protection, and dispute settlement) have been a part of bilateral arrangements, including Friendship, Commerce, and Navigation (FCN) treaties, for hundreds of years (Paterson 1991; Legum, 2001); Dymond and Hart observe that the NAFTA expropriation provision in Article 1110 have important antecedents in the Fifth Amendment to the US constitution. However the first of what is generally regarded to be a modern bilateral investment treaty was negotiated in 1959 between Germany and Pakistan (ICSID, 1999). There are currently close to 2000 such treaties, a significant number of which are negotiated with and between developing countries. What is also notable is the convergence in terms of scope and coverage with respect to many provisions in these agreements. Whether negotiated between developed and developing countries, or among similar countries, international investment agreements increasingly tend to follow the bilateral template that formed the basis of NAFTA investment provisions. These include non-discrimination (usually national treatment and MFN), and investment protection articles, dealing with such provisions as expropriation.

It is also true, however, that many BITs remain below NAFTA standards in terms of the structure of reservations and the right of establishment. Nonetheless, more broadly it could also be noted that a continuing impetus for these BITs, as well as the inclusion of investment provisions in regional trade agreements (e.g. FTAA) reflects the weakness of comprehensive investment provisions in the GATT and later WTO.⁹ Agreement to continue work on investment in the WTO at the Doha Ministerial in November 2001, with a view to confirming a negotiating mandate in 2003, represents an implicit acknowledgement of this.

The Policy Justification for Negotiating the NAFTA Investment Provisions

As the 1990s dawned consensus was growing with respect to both the sorts of principles that should be accorded to international investors and their investments and, most importantly, on the desirability of enshrining them in international investment agreements. Perhaps the best evidence for this lies in the NAFTA investment provisions.

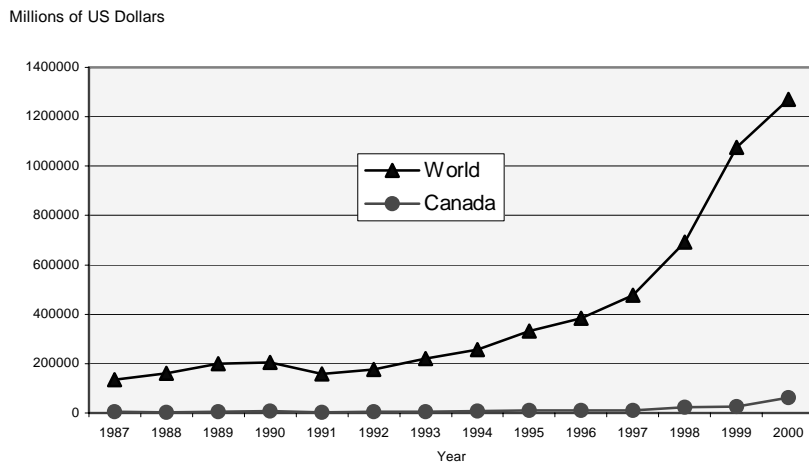
While it was not surprising that the US supported stronger investment provisions than those that existed in the FTA, the fact that both Canada and particularly Mexico agreed to them is noteworthy. These two countries were traditionally wary of US influence over their economies and had at times discouraged US investment.¹⁰ This had become much less acute by the mid-

⁹ The negotiation of the TRIMs Agreement and investment-related provisions of the GATS through mode 3 on commercial presence contributed to this patchwork.

¹⁰ This was particularly true of Mexico, which, along with many Latin American states, had enshrined what had come to be known as the Calvo Doctrine, whereby it was

1990s, however. Canada had changed its approach to FDI considerably over the previous decade, beginning in 1985, when the Foreign Investment Review Agency (FIRA), which reviewed most foreign investment in Canada with a view to confirming "substantial benefit" to Canada, was replaced by Investment Canada, whose mandate was to emphasize investment promotion as well as a much more streamlined and accommodating investment review procedure.¹¹

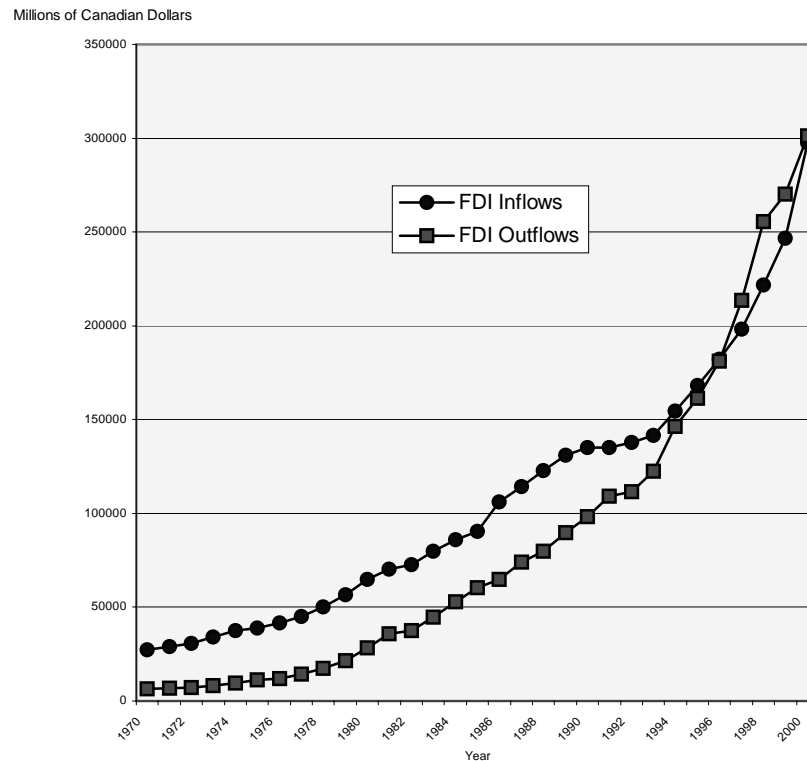
Chart 3 *FDI Inflows*



Source: UNCTAD, *World Investment Report*, various issues.

maintained that the sole means of resolving a dispute between a state and an investor within its territory must be judicial proceedings in domestic courts. See Graham and Wilkie, 1999.

¹¹ Canada, like other NAFTA signatories, had sectoral sensitivities that it protected in a number of ways: (a) through exceptions, either to Chapter 11 itself, or through the General Exceptions article to the agreement (Chapter 21); (b) through restricting the scope of the agreement (through definitions, for example); and (c) in reservations to Chapter 11 provisions. One example was the nurturing of Canadian cultural industries, protected in the NAFTA in the same manner as in the FTA. The wording of Article (Annex) 2106 in the NAFTA is: "Notwithstanding any other provision of the Agreement, as between Canada and the United States, any measure adopted or maintained with respect to cultural industries, except as specifically provided for in Article 302 (Market Access – Tariff Elimination), and any measure of equivalent effect taken in response, shall be governed under this Agreement exclusively in accordance with the provisions of the *Canada – United States Free Trade Agreement*. The rights and obligations between Canada and any other Party with respect to such measures shall be identical to those applying between Canada and the United States."

Chart 4 *Canada's International Investment Position*

Source: Statistics Canada, *Canada's International Investment Position*, various issues.

From Canada's perspective, NAFTA represented an opportunity to negotiate a comprehensive trade and investment agreement on a continental scale. Canadian negotiating leverage with respect to Mexico was not great, underlined by the low stock of Canadian direct investment in Mexico (just under \$US 580 million in 1992, versus \$US 23.1 billion for the United States).¹² Most importantly, however, it remained vitally important for Canada to consolidate the gains in both the trade and investment areas which were realized under the US-Canada FTA. From a Canadian perspective, it was important to trilateralize a US-Mexican agreement if only to reduce the tendency towards a series of US

¹² This asymmetry was echoed in trade data. At the time of the NAFTA negotiations (1992), the US was the destination for 81% of Mexican exports and 71% of her imports; the comparable figures for Canada were 2.2% and 1.7%, respectively. See *The Mexican Economy 1993*, Banco de Mexico, 317. Since that time, North American economic integration has increased.

bilateral agreements with her trading and investment partners which might compromise these gains (Hill and Wonnacott 1991; Wonnacott 1991).

Some Canadian critics indeed believed that US bilateral arrangements could undermine the whole multilateral process. Great importance was attached to ensuring that the US not become the "...hub of a rimless wheel...", with only the US able to realise advantages thanks to a series of bilateral agreements. Wonnacott went so far as to argue that "...from the point of view of world welfare, preventing this development is arguably the most important reason for Canada to trilateralize the [NAFTA] negotiations" (Wonnacott 1990).

This remains an important *raison d'être* for multilateralizing investment provisions in other fora, including any prospective comprehensive investment provisions in the WTO. For a middle power like Canada, it is important to anchor international trade and investment relations in a rules-based system, both regionally and internationally.

The NAFTA Investment Provisions¹³

Substantive Provisions (Section A of Chapter 11)

And what are these NAFTA investment provisions that are seen to be so controversial? When examined closely, and put into their broader political or historical context, there seems to be little justification to view them as not amenable to clarification. Those problems that do exist have been – and continue to be – addressed through ongoing work by the Free Trade Commission which is overseen at the Ministerial level. Let us first examine the main provisions in their policy context.

The first article of Chapter 11 is 1101 (Scope and Coverage). Among other provisions, 1101.1 states that the chapter applies to measures *vis-à-vis* investors of another Party as well as investment of investors of another Party in the territory of the Party (and *all* investments in a Party with respect to articles on Performance Requirements (1106) and Environmental Measures (1114)). In practice the scope of this chapter – and indeed most agreements – is defined not only by this eponymous article, but through the interrelationship of a number of provisions. Definitions that apply to the article are important (in Chapter 11's case, as outlined in Article 1139), and reservations and exceptions (described in NAFTA's Article 1108, outlined in detail in the Annexes to the agreement, and introduced below) are fundamental to the scope of the agreement.

The core substantive provision of contemporary international investment agreements is "national treatment", whereby foreign companies or investors are essentially treated the same as domestic (or national) companies. For the concept to hold in its entirety, this would have to be true of companies seeking to invest for the first time (pre-establishment) as well as companies seeking to change existing operations (post-establishment). The NAFTA national treatment obligation is comprehensive in this regard: it embodies right of establishment and an obligation of each signing party to accord to investors

¹³ Parts of this section are based on Graham and Wilkie (1999).

(and investments of investors) of other signing parties treatment "no less favourable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments" (Article 1102.1). This provision goes beyond those of other previously negotiated international agreements. Since the NAFTA, however, most, including Canadian FIPAs, have included similar articles.¹⁴

National treatment is often complemented and strengthened by most-favoured nation provisions in investment agreements, and this is no less true of the NAFTA. In the MFN (Articles 1103 and 1104) and minimum standard of treatment (Article 1105) provisions of the NAFTA, signing parties must grant investors and investments of other signing parties treatment no less favourable than that granted to investors and investments of non-signing countries and that provided for under international law. In addition, as with most provisions, the national treatment provisions of the NAFTA generally apply to "third party" investors and their investments. (For example, if a Canadian subsidiary of a European corporation holds an investment in Mexico, the Canadian subsidiary would be a "third party investor" and its Mexican subsidiary a "third party investment").¹⁵ However, under Article 1113, there are exceptional circumstances where these obligations could be denied.

The national treatment obligations apply to state and provincial governments, as they do in principle to regional and municipal governments and to subnational state agencies (Article 1108.1). As all three signatories are *de jure* federal states, constitutional considerations played a role in resolving subnational jurisdictional sensitivities associated with this. Subnational entities, like their federal counterparts, were initially required to list their non-conforming measures within a two-year time frame, but this requirement was later dropped as all subnational measures were grandfathered into the agreement.¹⁶ And again, subnational measures are also tempered by a number of reservations and exceptions that are detailed in annexes to the draft agreement, addressed below.

Another important feature of recently negotiated investment agreements has been a prohibition or limitation on performance requirements. Again, the NAFTA contains a provision to limit these restrictions on the behaviour of investors or investments in the territory of the signatory governments (Article 1106). This provision goes further than similar provisions negotiated in other international fora. In particular, the Uruguay Round's Agreement on Trade Related Investment Measures (TRIMs) to restrict certain

¹⁴ The APEC investment code followed the NAFTA and contained a national treatment obligation. Unlike the NAFTA, however, it is non-binding, and its influence and utility are debatable.

¹⁵ If the situation was reversed, i.e. the investor was from a non-Party, then it would not have standing under Chapter 11.

¹⁶ Reservations and exceptions for *local* government were effectively grandfathered since they were not required to be listed in the first place.

types of performance requirements is a weaker instrument than is NAFTA Article 1106. While there is a prohibition on several types of performance requirements in the TRIMs agreement, the sample list is narrower than that specified in the NAFTA and, as the TRIMs agreement itself states, it essentially codifies existing practices by prohibiting TRIMs that are “inconsistent with the provisions of Article III or Article XI of the GATT.”¹⁷

From an economic perspective, restrictions on performance requirements are logical because these requirements often result in much the same distortions as traditional trade restrictive devices.¹⁸ Article 1106 of the NAFTA is arguably stronger than the equivalent provision of the US-Canada FTA, itself quite a strong measure to ban most new performance requirements and to phase out most old ones. In particular, NAFTA’s ban on new performance requirements (and phase out of old ones) covers some additional categories permitted under the FTA.

Technology transfer and “exclusive supplier” requirements were added to the list of NAFTA prohibitions, covering export requirements, minimum domestic content, and domestic sourcing requirements (Article 1106.1). Furthermore, under Article 1106.3, the linking of subsidies with certain performance requirements such as domestic content, domestic sourcing, or trade balancing is also prohibited, as is the linking of sales to export requirements and the earning of foreign exchange.

There are mitigating circumstances however. Performance requirements to promulgate environmental standards are permitted (Article 1106.2; see also Article 1114), as are some performance requirements when linked to an advantage as outlined in Article 1106.4. Also, there is no ban on requirements for the performance of research and development (Article 1106.4), a provision which may have increasing national treatment repercussions in high-tech industrial sectors.¹⁹ And most important, it could be noted that NAFTA’s restrictive rules of origin requirements outlined in Chapter 4, like similar provisions in other agreements, serve as crude performance requirements of a sort, in so far as they favour production within the NAFTA.

While the performance requirements’ provisions are significant, Article 1105 on minimum standard of treatment, and Article 1110 on expropriation have also generated controversy.

Article 1105 sets out an absolute standard of treatment, unlike the relativist provisions embodied in national treatment and MFN. The text of the

¹⁷ The illustrative list of TRIMs includes domestic content requirements, trade balancing requirements, or restrictions on imports of products used in or related to the local production of a foreign-owned enterprise. It applies to goods only.

¹⁸ An examination of the economic effects of performance requirements and a bibliography of the relevant literature is contained in Edward M. Graham and Paul R. Krugman, “Trade Related Investment Measures”, in Schott.

¹⁹ Article 1106 of the NAFTA applies to performance requirements placed on any investment, not only investments of a country that is party to the NAFTA.

NAFTA Chapter 11 has been criticized as being vague in this area, among others, but has been dealt with to some degree in a recent clarification. This issue is addressed in more detail in other contributions to this volume; suffice it to say that the minimum standards of treatment article should mean what it says, and not represent a new standard.

As part of the July 2000 text clarification, NAFTA parties agreed that Article 1105 “prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors in another Party.”²⁰ The word “customary” was new, and the clarification went on to maintain that concepts such as “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.”

Article 1110 of the NAFTA pertains to expropriation and compensation for expropriated properties. It basically forbids expropriation except for a public purpose, and then it must be done without discrimination, and with due process. Provisions relating to these issues have long roots in international investment agreements, in that most Canadian FIPAs between developed and developing countries have sought to create conditions to ensure that if stability for investors could not be ensured, then as a second best alternative, some form of compensation would be forthcoming. In the North American context these have been contentious issues, particularly between the US and Mexico (and, in recent times, between Canada and certain Caribbean and South American countries).

The remainder of NAFTA Article 1110 is designed to ensure the effectiveness of the article by, for example, declaring that compensation payments should reflect market value (Article 1110.2), and that payments must be prompt and in a G7 (or fully G7-convertible) currency (Article 1110.2-1110.6), thereby avoiding undue investor exchange risk.

Article 1110 may be viewed as an achievement in the context of investment relations with Latin American countries, who have traditionally been wary of investment agreements. It should be recalled, however, that attitudes towards FDI have been changing in Latin America, as elsewhere, not least because of a growing realization that in order to attract scarce foreign capital, a liberal policy on expropriation and compensation was necessary.²¹

But it is undeniable that the expropriation article has been among the most controversial among the NAFTA articles (IISD, 2001). Among the concerns are that because of its reach, governments will be increasingly reluctant to regulate in the public interest for fear of investor-state dispute settlement cases. The prerogative of a state to regulate in the public interest on a

²⁰ See “Pettigrew Welcomes NAFTA Commission’s Initiatives to Clarify Chapter 11 Provisions.” DFAIT Press Release 116 (1 August, 2001).

²¹ The relevant article (1109) does not apply, however, to transfers associated with issuing, trading, or dealing in securities.

non-discriminatory basis was confirmed as recently as late September 2001, when International Trade Minister Pierre Pettigrew stated that "...the ability of governments to regulate in the public interest not be compromised by unintended interpretations of investment rules" (Pettigrew, 2001). The NAFTA parties on the subject also took up this confirmation in the July 31st, 2001 interpretation.

It is important to observe that compensation for expropriation itself is not a recent concept in international treaties, including international investment treaties. Indeed, even disregarding the non-controversial notion that outright confiscation warrants compensation, compensation for "disguised expropriation", or "creeping expropriation" (NAFTA uses the words "tantamount to expropriation") is not a novel nor rare concept in bilateral investment treaties (Wallace, 1982; Sornarajah, 1994; 282-284). This is not to say that it is a fluid concept; furthermore tribunals do take into account evolving conceptions of what constitutes a "taking" in national and international law, including in the United States.²² But again, takings and expropriation are common concept in international investment treaties, as evidenced by the inclusion of a study on the subject in UNCTAD's Issues in International Agreements series (see also Wilkie, 2001).

Canada has been keenly aware of the benefits further guidance could provide to panellists in interpreting international treaties. International treaty negotiation is an art, not a science, and the results are usually finely-balanced. They are living documents that often have to respond to different constituencies in a number of jurisdictions with different concerns and policy priorities. The July 31 clarifications of the NAFTA, which themselves have a long genesis in Canadian policy, exemplify this, as do the two other illustrations below.

First of all, in the negotiation of the 1994 Energy Charter Treaty, which Canada participated in but did not ratify, Canada and the US published a joint statement clarifying the text of the National Treatment article in that agreement (Article 10). This wording sought to clarify that for determining treatment "similar circumstances" would have to be examined on a case-by-case basis. In addition, in the context of non-discrimination, the following was also noted: "Legitimate policy objectives may justify differential treatment of foreign Investors or their Investments in order to reflect a dissimilarity of relevant circumstances between those Investors and Investments and their domestic counterparts."²³

Secondly, in the MAI negotiations, Canada, along with its NAFTA partners and indeed Ministers from all negotiating parties, indicated that they were sensitive to the continued "right to regulate", and furthermore that the

²² One analyst cautioned recently that evolving domestic case law in the US had extended traditional notions of takings; see Graham, 1998.

²³ For the full text of the Energy Charter Treaty, including the Canada US understanding on national treatment, see: <http://ecs.icl.be/english/fulltext/treaty.html>; see also their new site at: <http://www.encharter.org/index.jsp>.

“normal non-discriminatory” exercise of these powers “would not amount to expropriation.”²⁴

For different reasons, neither of these formal understandings became part of Canadian law. But they are noted here since they illustrate (a) Canada’s continued work fleshing out treaty wording on sensitive issues; and (b) the fact that our most important trading partner was also prepared to agree to these understandings. These facts, coupled with the NAFTA Parties commitment “...to continue to work on the implementation and operation of Chapter 11, including developing recommendations as appropriate” are significant. It is perhaps not too optimistic to suggest that Canadian efforts to further clarify the NAFTA investment provisions agenda will continue to bear fruit.²⁵ Parenthetically, it could be noted that although not fully sharing the concerns as expressed by IISD with respect to Chapter 11, Canada has moved in the direction of the suggestions for change through its work on a clarification and opening up the process (IISD/WWF, 2001).²⁶ And further work in this regard by the NAFTA Free Trade Commission continues.

Investor-State Dispute Settlement in the NAFTA (Chapter 11, Section B)

The investor-state dispute settlement procedures of Chapter 11 are innovative, but are an entirely understandable next step in the evolution of a non-discriminatory framework for the protection of international investment.

The reach of the NAFTA investment provisions is partly due to the set of procedures for resolving investment disputes (Section B - Articles 1115 through 1138). Due to their innovations, they set an important precedent for any future multilateral agreement on investment. Under these procedures in the

²⁴ The excerpt from the 1998 Ministerial statement on the MAI reads as follows: “Ministers confirm that the MAI must be consistent with the sovereign responsibility of governments to conduct domestic policies. The MAI would establish mutually beneficial international rules which would not inhibit the normal non-discriminatory exercise of regulatory powers by governments and such exercise of regulatory powers would not amount to expropriation.” See Communiqué - OECD Council Meeting at Ministerial Level, Paris, 27-28 April - Ministerial Statement on the Multilateral Agreement on Investment (MAI) at: <http://www.oecd.org/media/release/nw98-50a.htm>.

²⁵ See “Canadian Memo Identifies Options for Changing NAFTA Investment Rules,” *Inside US Trade*, February 12, 1999, in which Canadian officials outline a number of options to aid in clarifying NAFTA Article 1110 on expropriation.

²⁶ IISD/WWF suggested three changes for the reform of Chapter 11 procedures: (a) issuing a formal “interpretative statement” clarifying the Chapter 11 rules to avoid future abuses of language relating to expropriation and other investor protections; (b) considering a limited reopening of NAFTA’s investment provisions – only so far as necessary to amend its procedural rules – to allow changes that cannot be addressed through an interpretive statement; and (c) taking all possible immediate steps to open the Chapter 11 process, such as opening hearings, releasing transcripts, admitting *amici curiae*, and publishing rulings.

NAFTA most investors (but not investments) may seek arbitration of a dispute against a signing party to the NAFTA. In other international dispute settlement mechanisms, including those of the FTA and the GATT, only governments have "standing", and hence an investor must be represented by a government (usually its home government) in seeking resolution of any claim it might have against another government. Under NAFTA, however, an investor can pursue a claim on its own behalf (or on behalf of its investment) against a signing party if it can claim monetary loss or damages involving alleged breaches of obligations under Section A of Chapter 11 or certain other articles of the NAFTA.

An effort must be made to solve the dispute first by means of consultation and negotiation (Article 1118). If this fails, the dispute can then be submitted to binding arbitration under the rules of the World Bank (International Centre for Settlement of Investment Disputes (ICSID) Convention) or the United Nations (United Nations Commission on International Trade Law (UNCITRAL)). Under either set of rules, a Tribunal (arbitration panel) is established that is empowered to order interim measures to protect the rights of the disputing investor. Although the Tribunal cannot order a government to revoke a measure alleged to constitute a breach of the NAFTA, it can order that an award be made to the investor, including monetary (but not punitive) damages and/or restitution of property, plus applicable interest (Article 1135.1). If the claim is made by an investor on behalf of an investment, any award granted by the Tribunal is without prejudice to any right that the investment might have to relief under domestic law.

In the context of international investment relations in the Western Hemisphere these provisions resolve longstanding and fundamental differences over the Calvo Doctrine.²⁷ The significance of this shift in Mexican political thinking cannot be overstated, since for over a century the Mexican government had argued much as they did at G-77 discussions in the 1970s over the New International Economic Order:

...it should be the internal legal order which establish[es] the procedures and means of compensation. What is not to be tolerated, and what the overwhelming majority of countries have therefore completely rejected, is that instead of or in addition to the national legal system, other bodies or extra-national procedures should be called on to rule on what a State should do in such cases.²⁸

Now that the NAFTA and Canada-Chile Free Trade Agreement, as two recent trade and investment treaties including Latin American parties, incorporate investor-state dispute settlement procedures, it will be interesting to see whether

²⁷ See note 9.

²⁸ Official Records General Assembly, 2315th meeting, 12 December, 1974, 1377-8, para. 162, as quoted in Schrijver, 1997.

the FTAA will incorporate such procedures. They are certainly under consideration by negotiating parties.²⁹

Unlike the traditional dispute settlement mechanisms embodied in Chapters 19 (antidumping and countervailing duties) and Chapter 20 (state-state disputes) of the NAFTA, none of the arbitration mechanisms mentioned in Chapter 11 (ICSID, ICSID's Additional Facility, or UNCITRAL) contain any time limits on actual arbitration. Articles 1116-1120 and 1126-1127, however, do impose strict time limits on what the parties to a dispute must do to initiate and/or respond to proceedings (Horlick and DeBusk, 1993).

The NAFTA investment dispute settlement mechanism embodied an important departure from traditional investor-state dispute settlement, at least insofar as an agreement that included more than one developed country signatory. Under traditional investor-state dispute settlement, both parties must customarily agree to initiating proceedings, while Article 1120 of the NAFTA allows the investor to unilaterally initiate them. This was a departure from traditional ICSID practice. Furthermore, Article 1136.5 goes on to say that in the event of a signatory refusing to abide with a final award, a Chapter 20 panel may be instituted, with a request that the Party ultimately comply with the award (Horlick and DeBusk, 1993). No circumstances have arisen thus far for the latter to occur.

Early in the negotiations, the ICSID and the International Chamber of Commerce (ICC) were both suggested as institutions for commercial arbitration.³⁰ However, it was only ICSID that resurfaced as part of the agreement, despite the fact that the ICC receives over 300 requests for its facilities every year, and approximately one-third of cases involves a state entity.³¹ Admittedly, the ICC has been hesitant to involve itself too heavily in arbitration of disputes not strictly commercial in nature.³² However, there is nothing to stop signatories from ultimately encouraging the use of other institutions and facilities for the resolution of commercial dispute settlement - indeed this is stipulated under Article 2022 and, with respect to conciliation procedures rather than more formal arbitration, Article 1118 of the investment chapter.

²⁹ See FTAA Agreement, Chapter on Investment, available on the FTAA website at: <http://www.ftaa-alca.org>.

³⁰ *Inside US Trade*, vol. 10, no. 5, January 31, 1992, 10.

³¹ Toope 1990,205; 213, n.55. Precedents also already exist for ICC arbitration to be stipulated in investor-state contracts. See also W. Michael Reisman 1989, 757. Indeed an international lawyer affiliated with the ICC in the 1960s pointed out that the involvement of the ICC in investor-state dispute settlement was common, and had been so since 1922. Furthermore, an example was noted of an ICC arbitration clause in a contract between the Nigerian government and a Canadian oil company in the 1960s. See Böckstiegel 1965, 581.

³² See Part IV "Resolving Extraterritoriality Problems" in Lange and Born 1987, 44-57.

Mechanisms for the improvement of the already innovative investment dispute settlement mechanism are embodied in the NAFTA. Chapter 20 establishes the more traditional sovereign state dispute settlement procedures for disputes similar to those of Chapter 18 of the FTA, and these can be invoked as an alternate means for settlement of investment disputes if both parties to a dispute agree that it is necessary (and Chapter 20 procedures can also be used, of course, for disputes other than investment disputes).

NAFTA also includes an article on alternative dispute resolution (Article 2022). Subject to the will of the signatories, this article could have implications for investment dispute settlement as well. Article 2022.1, for example, stipulates that signatories “shall, to the maximum extent possible, encourage and facilitate the use of arbitration and other means of alternative dispute resolution for the settlement of international commercial disputes between private parties”. As we have seen, this notion was also given impetus within the investment dispute chapter under Article 1118. Thus other more informal and presumably less costly venues and vehicles for dispute settlement could be encouraged - these could include the ICC, or any number of new centres from British Columbia to Cairo that have recently been established to help in dispute settlement. Notably, provision for this has also been accommodated in the NAFTA in that Article 2022.4 states that an Advisory Committee on Private Commercial Disputes shall be established, again with the intention of furthering the resolution of these disputes. Under Article 2022, the emphasis would be on conciliation rather than arbitration. Without formal state involvement, the opportunity would be present for quick, low profile, low cost resolution of commercial disputes.

But these latter points are conjectural. It was quickly apparent that the investor-state dispute settlement mechanism of the NAFTA investment chapter was among the most innovative features of the agreement. While they have generated controversy, all subsequent international investment negotiations have taken them into account. Indeed calls are beginning to be heard for a widening of the NAFTA approach to facilitate domestic entity access to these procedures in an effort to further private rights against the arbitrary, unfair, or discriminatory actions of the state (Dymond and Hart, 2002).

Reservations and Exceptions to Chapter 11

The NAFTA contains many other reservations and exceptions to the provisions of Chapter 11, most of which are spelled out in the annexes to the agreement. Mexico continues to exclude the petroleum sector from foreign direct investment. With respect to the US the whole of the maritime sector is excluded, and, with respect to Canada, continuing cultural exemptions are unique. The reason for the Mexican exclusion is because the Mexican Constitution stipulates that the petroleum sector is to remain state-owned. Indeed, Mexico retains several constitutionally-mandated foreign investment restrictions in other sectors, listed in Annex III (indeed Mexico is the only signatory with Annex III exceptions).

NAFTA signatories have outlined General Exceptions to the agreement in Chapter 21. Taxation measures, for instance, are carved out (Article 2103), and Canada has retained the cultural carve-outs of the FTA (in Article and Annex 2106 of the NAFTA). Otherwise, however, Canada continues to liberalize: Canada further liberalized the Investment Canada Act to allow NAFTA investors access to the oil and gas sectors at the same \$150 million threshold as for other sectors, at the same time as a new policy framework for book publishing, and other cultural policy changes, was also announced.³³

The full lists of reservations, exceptions, and sectors reserved for the state are contained in Annexes I-IV of the NAFTA.³⁴ Annex I restrictions cover investment restrictions in industries that are grandfathered and cannot be made more restrictive than they already are. Annex II restrictions, by contrast, are subject to increasing restrictions. These include US investment restrictions in the maritime industry, as well as a number of sensitive social sectors for all three signatories. Annex III restrictions, as already noted, are limited to those mandated by the Mexican constitution.

In addition, both Canada and Mexico are allowed to continue with review of certain investments and, for all intents and purposes, this also may be said of the US with respect to national security provisions. Decisions taken pursuant to Annex 1138.2, for example, under which decisions taken by Canada under the Investment Canada Act and by Mexico through the National Commission on Foreign Investment with respect to whether an acquisition should be allowed to proceed, are not subject to the investment dispute mechanism.³⁵ Under Article 1138, this exclusion also extends to actions "taken by a Party pursuant to Article 2102". Article 2102 is a national security "carve-out" that also allows a signatory to take actions "deemed necessary for the protection of its essential security interests", relating to traffic in military goods, materials, and technology, or taken in time of war or other international emergency, or relating to nuclear proliferation. Thus Article 1138 also renders decisions taken by the United States to block Canadian or Mexican acquisitions of US firms under the Exon-Florio provision of the Trade Act of 1988 as not subject to the investment dispute settlement mechanism, or at least not if such

³³ "Amendment to the Investment Canada Act", *Investment Canada Press Release*, June 18, 1992. The bill formalizing these provisions was enacted in June 1993. Canada also multilateralised these changes to WTO members during the Uruguay Round.

³⁴ There are seven annexes. Annexes I-III are covered in Gestrin and Rugman 1993, 12-19; see also Hufbauer and Schott 1993. Annexes IV-VII cover mostly historical carve-outs in all three countries, such as broadcasting, aviation, fisheries, postal services, etc.

³⁵ Under Annex 1607.3 of the FTA, Canada agreed to increase the threshold of reviewable direct acquisitions by US investors from C\$ 5 million to C\$ 150 million in four years, and to eliminate the review of indirect acquisitions by US investors over the same period. There was also a minor change to the method of calculation of the annual adjustment for the review thresholds, the effect of this was to adjust the thresholds for economic growth as well as inflation.

blockage is consistent with Article 2102. It could be argued that here was an implicit trade-off between Exon-Florio and other US national security type exceptions with an acceptance of Investment Canada and CNIE exclusions from dispute settlement (Annex 1138.2).

There are other domains where Chapter 11 investment dispute settlement provisions do not apply or apply with qualifications. For example, Article 1307 makes the status of the telecommunications sector with respect to the Chapter 11 investment dispute mechanism ambiguous. Under Article 1415 pertaining to financial services, the investment Tribunal must refer to the Financial Services Committee (Article 1412; Annex 1412.1) to rule whether disputes in this sector are to be subject to the investment dispute mechanism. This would seem to at least discourage the use of the mechanism in this sector. Finally, reflecting the greater relative importance of state enterprises in the Mexican economy, state enterprises are treated in a separate chapter (15) of the NAFTA, whereas under the FTA they were dealt with under a national treatment exception clause of the investment chapter (FTA Article 1602.5-7). Although state enterprises, including in the exercise of governmental authority, are subject to Chapter 11 (Article 1503.2), anti-competitive practices are not (Article 1501) (see also Articles 1116 and 1118).

The reservations and exceptions are a key component determining the scope of Chapter 11. They offer policy flexibility, including with respect to continuing to favour domestic investors and the right to discriminate against foreign investors in a number of sectors in Annex 1. Annex 2 gives these same rights for a number of broad sectors, including with respect to unspecified future measures. These are a vitally important element in determining the scope of the NAFTA investment provisions, and are often ignored.

Conclusion

Viewed in their entirety, the formal investment provisions of the NAFTA consist of Chapter 11's substantive provisions (as further refined through the scope of the agreement), definitions, and the reservations and exceptions (including, for example, for environmental measures as outlined in Article 1114 and with respect to cultural industries in Article and Annex 2138). They offer a degree of policy flexibility with respect to a number of economic sectors, and otherwise anchor Canadian international investment policy within a framework that lays the groundwork for continued growth in international investment flows among NAFTA signatories.³⁶ Expanding this work to other fora is a key component for further diversifying the sources and destinations of Canadian FDI and CDIA, and in realising the many benefits that FDI can bring to the Canadian economy.

There is a continuing trend toward establishing a framework for burgeoning international investment flows. This is manifested at the bilateral and increasingly regional level. A rules-based system is particularly important

³⁶ Canada has attracted a steadily declining proportion of global FDI flows since the early 1980s. See Industry Canada (2000a).

to countries with medium influence such as Canada. The type of rules negotiated, including in the NAFTA, enjoy historical precedent in the trade domain and are increasingly influential in the investment domain internationally. In this context, while the NAFTA investment provisions are innovative, they do not represent the radical departure from evolving practice in the trade and investment system. Indeed as firms globalize and trade and investment activities are increasingly viewed as complementary, it could be argued that it is in the interests of governments and their citizens to multilateralize such provisions.

Governments complement the activities of firms at the unilateral level by seeking to provide a regulatory environment that will bring to their jurisdictions the benefits that FDI can bring. It is impossible to say with certainty that NAFTA investment provisions have contributed to increasing investment flows to and from Canada. However there are increasing indications that a thirty-year trend of Canada's declining world share of FDI can be arrested. That this can be attained while accompanied by increasing Canadian direct investment abroad makes it an enviable accomplishment that should stand Canadian economic prospects in good stead in the years ahead.

Finally, Canada has committed itself to ensuring that these accomplishments will be consistent with the goals of sustainable development and the rights of government to regulate its economy on a non-discriminatory basis. Continuing work in this vein, including that of the NAFTA Free Trade Commission, has already demonstrated this. Constructive voices advocating a better-managed system consistent with these goals will contribute to the likelihood of further success in the future.

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Commentary

Dennis Browne

Before getting into the substance of my remarks, I would like to congratulate the sponsors and organizers on the job they have done in preparing for this conference. I would also like to thank Christopher Wilkie for a well-written paper that was a pleasure to read. Rather than comment directly on the paper, *per se*, I should like to make a number of comments in reaction to some of the points made in the paper and in Dr. Wilkie's presentation this morning. First, a comment on bilateral investment treaties, which Canada calls 'FIPAs' and most others call 'BITs'.

Dr. Wilkie is, of course, correct to note their proliferation. I understand there are currently almost 1800 of them in place around the world. To my knowledge, all current BITs are between developed and developing countries or economies in transition. None has been negotiated between two developed countries. Hence, BITs are generally based on developed country concerns about lack of legal fairness and/or uncertain legal regimes in developing and transition economies. Investor-state dispute settlement provisions are probably included in BITs because, once an investment has been expropriated, whether for a legitimate public purpose or not, the hapless investor has no standing in the courts of the host country and would have to rely on its home government to act on its behalf. This would take the initiative and its management away from the party whose interests are directly at stake and possibly mix it in with broader political considerations.

A question arises as to whether we should consider BITs as substitutes for or precursors to a multilateral agreement on investment. Some would say that 1800 similar bilateral agreements would lay a very good foundation for a multilateral agreement of similar design, especially if the bilateral agreements include MFN clauses. Table 2 in Dr. Wilkie's paper shows that Canada has signed 23 FIPAs (now 24 as Czechoslovakia has split), two of which are not yet in force. The list of bilateral partners appears to be quite peculiar with no immediately apparent rhyme or reason. This could make one wonder how real they are. How many were negotiated because of an upcoming Ministerial visit with nothing else worth signing on the agenda? Were they 'photo-ops' or are they substantive elements in Canada's bilateral relations with the signatories? The agreement with South Africa was signed over six years ago, but it has not yet entered into force. Surely if the two parties wanted the agreement to be in effect, it would be in effect by now. The agreement with Costa Rica was signed over three years ago and has languished. It has, however, been overtaken by events as we are currently negotiating a bilateral free trade agreement with Costa Rica that almost certainly has an investment chapter modeled on NAFTA Chapter 11. How many FIPAs were negotiated because the Canadian business community actually asked for a particular FIPA? Probably none.

About three years ago, a graduate student at the Norman Paterson School for International Affairs wrote her thesis on Canada's FIPAs. She

identified Canada's policy rationale for FIPAs to be their capacity to improve the investment climate in countries of interest, thereby encouraging Canadian firms to invest in signatory countries. She did not, however, find empirical evidence of this encouragement. She interviewed senior officials of a number of Canadian firms with investments in developing countries and in transition economies, asking whether the presence or absence of a FIPA was fundamental to their investment decisions. All replied in the negative. Commercial opportunities and political risk assessments were the main bases for their decisions. (In all likelihood, the presence or absence of a FIPA was taken into account in the political risk assessment, but indications were that it was not a prime consideration.) The student could not find any examples of a Canadian investor making use of the investor-state provisions of a Canadian FIPA, but she was not sure if this meant that FIPAs are unnecessary or if it meant that FIPAs encourage host governments to behave more fairly towards Canadian investors.¹ This is not to say that FIPAs have no value. But it does bring to mind counsel I received from my supervisor when I first began participating in multilateral discussions and negotiations. He told me, "Be careful not to fall into the trap of believing your own rhetoric."

Chapter Sixteen of the bilateral Canada/USA Free Trade Agreement was, I believe, the first bilateral investment agreement between two developed countries. Why was that? Why was it considered appropriate to include it in the FTA? I don't guess it was because Canada and the USA wanted to set a model for the rest of the developed world to follow. It undoubtedly reflected the reality that bilateral investment flows, especially towards Canada, were a significant element in the overall commercial relationship. It also undoubtedly reflected a US concern that Canada, with its FIRA and National Energy Policy, had been behaving badly and had to be reined in or fenced in.

This is borne out by the relative modesty of Chapter Sixteen compared to BITs and Chapter 11 of NAFTA. The bilateral FTA chapter concerns itself with national treatment of 'other party' investors and investments and requires changes to Canada's FIRA and its application. Hence the Americans, with Chapter 16 of the FTA, reined Canada in so that the discriminatory treatment of the National Energy Policy could not be repeated and certain 'performance requirements' would no longer be sought under FIRA as a condition for right of establishment. What's more, the scope of US investments subject to FIRA review was considerably reduced.

Investor-state dispute settlement was not included, probably because each party expected their investors to receive fair (i.e. 'legal') treatment from the other party. The initiative to include Chapter Sixteen was clearly American, but

¹ Author's note: During symposium discussions, it was noted that a student would not be able to find evidence of investor-state arbitration as such disputes are almost always highly confidential -- in line with ICSID and UNCITRAL rules. Participants knew of at least one such arbitration, but were not free to disclose the identity of the parties to it.

some revisionist historian might some day decide to give Canada credit for beginning to recognize that if we were to get full benefit of an FTA, we needed to foster a high degree of economic integration and that included establishing and ensuring an investment-friendly climate on both sides of the border.

Dr. Wilkie's paper notes that chapter sixteen of the bilateral FTA was much more modest than Chapter 11 of NAFTA. This makes sense. NAFTA includes a developing country and Chapter 11 reflects the concerns of developed country investors about developing country treatment of them and their investments. For example, it considerably expands the limitations on performance requirements and introduces investor-state dispute settlement. With respect to the latter, one could almost certainly surmise that Canadian and US negotiators did not anticipate that their governments would fall victim to successful foreign investor arbitrations. They may well have anticipated that lawyers representing 'other party' investors would seek to make use of this provision, but they were probably confident that the laws, regulations and practices of their governments would not be found wanting. The goal was to bring Mexico up to our standards of treatment.

If you will excuse a truly facile observation, the exceptions to Chapter 11 take up far more room than the chapter itself. The chapter with its interpretive/operational annexes takes up 29 pages. The 'exceptions' annexes cover nearly 200 pages: Mexico accounts for about half of those pages; Canada for about one third and the USA for about a fifth. As facile as the observation is, it does illustrate the difficulties even developed countries face in granting rights of establishment and national treatment within binding and enforceable rules.

I understand the problems of the 'ill-fated' MAI reflected the North American experience somewhat. Prior to the bilateral Canada/USA FTA, which was and is exceptional, developed countries did not negotiate investment agreements (BITs) between themselves and there was little or no perceived real need for a plurilateral treaty limited to developed countries, i.e. members of the OECD. If the motive was to provide a 'demonstration effect' to lay the groundwork for a true multilateral investment agreement, it was spoiled by the seemingly endless list of exceptions that would have had to be attached to it.

The investment chapter of the Free Trade Area of the Americas (FTAA) will almost certainly be modeled on NAFTA. Will it provide sufficient demonstration effect to bring an investment agreement/chapter into the WTO? It's difficult to say. Developing countries will certainly be watching to see how onerous the NAFTA investment provisions are and then to see what effect they might have on investment flows and benefits gained by developing countries from them. As such, benefits are not likely to be apparent or proven in the short to medium term, any useful demonstration effect of the FTAA may be a long time coming.

In my view, if the GATS is ultimately seen to be a successful agreement for developing country members of the WTO, then some combination of the approaches used in the GATS and NAFTA Chapter 11 might, in fact, be the most saleable model for the WTO.

In this company, I guess it is either brave or foolhardy to praise Maude Barlowe. Nonetheless, I believe she was the first to bring public and political attention to the apparent imbalance in Chapter 11 that gives rights of action to foreign investors that are not necessarily available to domestic investors (especially in Canada). I am happy to see the treatment of this issue in the Hart/Dymond paper and I agree with their recommendations in this respect.

Finally, a comment on investment flows. When Rob Wright was Deputy Minister of International Trade, he expressed disappointment that NAFTA had not generated the levels of inward investment to Canada that had been hoped for. In fact, he identified that as NAFTA's only real failure. The penultimate paragraph of Dr. Wilkie's paper notes "increasing indications that the thirty-year trend towards Canada's attracting a declining world share of FDI can be reversed." Apparently he is not referring here to the declining value of the Canadian dollar (which makes Canadian investments a bargain for many foreign investors) as he goes on to say, "That this can be attained while accompanied by increasing Canadian investment abroad makes this an enviable accomplishment that should stand Canadian economic prospects in good stead in the years ahead."² Wilkie's Chart 4 shows Canada's FDI inflows and outflows to be roughly in balance. A question now is: Which, if either, should the government promote more vigorously, and why?

Dr. Wilkie notes that much of Canada's FDI is Canadian generated. Anyone who has been involved in promoting FDI into Canada has known for years that existing foreign investors in Canada are the best prospects for new FDI. The paper notes that we increasingly seek FDI, not for net additions to our pool of investment capital, but for "non-financial benefits, including technological know-how, marketing and other management practices, the demonstration effect vis-à-vis efficiencies picked up by domestic firms, linkages to regional or international markets, as well as other spillovers -- not least among these employment opportunities."³

This point is strengthened in the Hart/Dymond paper regarding the growing importance of intra-firm and other non-arms-length trade being a central characteristic of globalization. So, if Canada is going to actively promote inward FDI, we should be targeting investors that will bring these benefits rather than just money and jobs.

Should Canada promote outward FDI? Quite frankly, I am not sure how that can really be done, but Canada should certainly facilitate it. When I was serving in Stockholm ten years ago, Sweden, with an economy about equal in size to Ontario's, was home to a dozen of the Fortune 500 corporations. Canada, not just Ontario, was home to two. Sweden's industrial prowess and much of its wealth was based on MNEs that began in Sweden and grew to be world players. It seems to me that if Canada wants to become a more mature economy, it should seek to have more and more Canadian companies with FDI

² Wilkie, 25.

³ Wilkie, 10.

abroad. The goal should be to see outward flows grow faster than inwards flows, while, of course, maintaining a health rate of domestic growth.

At the beginning of my remarks I disparaged Canada's modest and somewhat peculiar list of FIPAs, but as trans-border economic integration proceeds, investment rules are going to become at least as important as trade rules and our objective should be to ensure that they are balanced and leave sufficient room for legitimate domestic regulation.

Thank you.

Commentary

Daniel Schwanen

Christopher Wilkie's paper represents the state of the art as far as its subject matter is concerned, namely the economic and policy considerations behind the NAFTA's provisions protecting investors and their investments, and other agreements containing similar provisions. As such, the paper is well worth the read. Nevertheless, I find some elements of it somewhat puzzling. Here, I will highlight three such elements that concern not only this paper, but more generally the Canadian debate over agreements, such as the NAFTA's Chapter 11, which protect investments and investors.

First, I am always struck by the attention given, when discussing the need for these agreements, to the size of Foreign Direct Investment (FDI) coming into a host country, relative to either some measure of economic activity such as GDP, or total global FDI flows. I do not believe that there is a theory or an empirical evaluation that suggests that there is an appropriate level of FDI for an economy, relative to these other metrics. Hence, these measures cannot tell us much about the impact of, or the need for, specific investor protection agreements.

One would surmise that large, diversified open economies would tend to rely less on either inward or outbound FDI than smaller, more specialized, open economies. And we would understandably guess that there is likely something wrong with an economy that attracted only minimal levels of FDI. But that does not make economies with high FDI to GDP ratio, such as Liberia, which tops the list, into economic powerhouses.

In general, therefore, these numbers do not tell us much about the rationale that each country may have to enter into such agreements. Furthermore, it is entirely possible for an established economic power such as Canada, with a long tradition of inward FDI, to experience at some point a reduction in its share of global FDI flows, without this constituting a negative sign for the economy.

There are, after all, other economies in the process of opening up to FDI, such as Mexico or China in recent years, with or without provisions such as the NAFTA's. These economies will naturally attract a higher share of FDI than previously, meaning a relative decline for other potential destinations, such as mature economies. If fixed investment growth financed from domestic sources is adequate, and FDI only one among many substitutable sources of technological progress, a reduction in FDI as a share of the economy is not necessarily a meaningful harbinger of poor economic performance. This is *a fortiori* true of a reduction in a country's share of world FDI. Nobody can seriously argue that foreign investment pouring into Mexico or China is bad for Canada as a whole – although a shift of certain types of investments away from Canada may indeed signal the decline of specific activities in this country.

A second area of puzzlement also concerns the discussion surrounding aggregate FDI data. After arguing on the one hand that FDI is good for Canada,

many authors will on the other hand remark apologetically on the current level of FDI – insisting for instance that Canada is well within international norms, that the current level is not ‘too high.’ Perhaps this ambiguity reflects battle scars from involvement in debates such as those surrounding the ill-fated Multilateral Agreement on Investment. Be that as it may, it shows that the discussion, framed as if more FDI were better than less, but that there can also be ‘too much’ FDI in an economy, is of limited usefulness.

The upshot of the discussion around numbers, or at least aggregate numbers such as those presented in this study, is that Canadian policy should not aim at attracting FDI *per se*, or set out as a policy goal to attract more or less FDI than others, but more simply at making Canada an attractive place to grow and maintain an enterprise in general (this is, of course, easier in principle than in execution). By definition, this means welcoming FDI in general, and revisiting current restrictions where they appear to be sapping the vitality of Canadian industry (e.g. the cultural sector). But it does not exclude remaining vigilant about any anti-competitive impact of a large FDI inflow on the domestic economy (e.g. if the investor refuses to deal with Canadian suppliers), or about whether foreign ownership might hinder the enforcement of domestic regulations in specific areas.

Which brings me to a third source of puzzlement, this time concerning the qualitative debate over the nature of the protection afforded investors and investments under the NAFTA’s Chapter 11. Here again, the paper gives us an excellent overview of the origin and meaning of the chapter. However, it also develops something of a split personality over the issue. On the one hand, the precedent-setting nature of investor-state dispute settlement provisions in the NAFTA is emphasized. On the other hand, there is an insistence that such provisions are not revolutionary, but evolutionary. Perhaps the latter is meant to appease critics of these provisions.

In any event, my point is that whether Chapter 11 is revolutionary or evolutionary does not matter all that much. Even under the latter hypothesis, the paper admits that evolution can be unhealthy to a point, since it goes on to explain why clarifications were sought and obtained by Canada concerning the interpretation of Chapter 11’s expropriation provisions. In essence, these clarifications sought to ensure that the provisions would not be misinterpreted in ways that would compromise the ability of governments to regulate in the public interest.

These clarifications – and others which I believe are yet to come as more cases make their way against US government actions – are welcome, and not only from the point of view of those who have been the most vociferous critics of the NAFTA’s Chapter 11 and of similar provisions elsewhere. The critics contend that these provisions do not simply provide a procedural bulwark against governments intent on favouring local interests to the point of abusing the interests of foreigners, but that they impose substantive limits on the ability of governments to regulate for the public good. The record of disputes so far does not suggest that the critics are right – but neither can the record prove that

they will be wrong in the future. As a result, there is a ‘regulatory chill’ that affects governments wary of being dragged into disputes with foreign investors.

But there is a good reason why economic conservatives – including staunch defenders of property rights – should also welcome clarifications made to the expropriation and dispute settlement provisions of Chapter 11. There is little doubt in my mind that these provisions of Chapter 11, as originally drafted, have also resulted in what I would call ‘deregulatory chill’ – a phenomenon potentially inimical to economic efficiency and growth. This is because governments in some cases have found experimenting with deregulation and privatization more difficult politically since the NAFTA, since their ability to re-intervene in the future to correct any course of action once it is taken is severely questioned by some legal analysts. The debate of three years ago over expanding the role of private health clinics in Alberta is an example of this difficulty.

Naturally, if investor protections as they were originally set out in the NAFTA, were crucial to attracting standard-of-living-enhancing FDI, then we might think twice about ‘clarifying’ them, for fear of watering them down. But there appears to be little evidence that these provisions actually played a significant role in promoting beneficial cross-border FDI. The rationales offered for them in Wilkie’s paper, for example, are qualitative, and probably important (e.g. preventing a U.S. investment ‘hub’), but not enough to support the statement that these agreements have been ‘fundamental’ to the consolidation of trends toward expanding FDI, whether between Canada and the United States or at the global level.