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The Impact of State-Investor Contracts on Development

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Question

What evidence is there on the impact of State-Investor Contracts on development? What concessions do governments give investors and do these affect the country's future development?

Contents:

1. Summary

A State-Investor Contract is an agreement between the government of a country and a foreign business investor, often, but not always supported with a Bilateral Investment Treaty (BIT), which is an agreement between two States. While rules governing trade, competition and investment are becoming global norms, health and environmental protection, social and labour rights, are mainly issues of international negotiation and domestic regulation, limiting the tools for protecting social and environmental interest. In order to attract foreign investors, governments promise favourable treatment of the investors with investment contracts or concession agreements that include stabilisation clauses, freezing clauses, economic equilibrium clauses and taxation provisions, among others. The literature makes a strong case that these clauses and arrangements have a negative impact on human rights, domestic legislation and public regulation. Furthermore, the lack of transparency undermines the ability of individuals and groups affected by the investment project to have a say on whether and under what conditions the project should be undertaken.

Overall, the literature on State-Investor Contracts (and investment treaties) shows that governments in particular in developing countries are the most affected. They are the countries that need foreign capital the most for their development and therefore are willing to make concessions to attract foreign investment. However, the evidence in the literature is very mixed on the real impact on host countries. Direct benefits or through spill-overs (horizontal or vertical) in technology exchange, knowledge exchange, labour markets, entrepreneurial development etc. are mainly based on assumptions.

- The literature makes a strong case that developing countries, in particular in sub-Saharan Africa and Low-Income Countries (LICs) do not have the absorption levels that are required to benefit from foreign investments. Some literature even shows negative spill-overs due to crowding out of domestic competitors and investment.
- Government are watering down on the introduction of new laws to protect environment and human rights for the threat to pay high compensation to foreign investors for breaching the stabilisation clause.
- There is also evidence that through State-Investor Contracts local people are pushed away from their land.
- Evidence also shows that tax income goes down because tax incentives are given to foreign investors and due to the practice of price shifting (international corporations shift money internally within its international network out of a country with high tax rates to another country with lower tax rates).
- Gender issues are absent in negotiations, because of a lack of women who participate in investment negotiations.
- Remedy and compensation through legal settlement mechanisms is often not given or enough for local populations, while foreign investors can rely on international norms that protect them and have access to international tribunals when they assume contract breaches.

The literature suggests that we could have reached a tipping point. For the first time there were less BITs in force in 2017. Responsible Frameworks and Guidelines are promoted worldwide (e.g. UNCTAD, UN Human Rights and OECD) and the capacity of negotiators from developing

countries is improving. However, the literature does not adequately discuss the impact this has on the content of new investment contracts (how they have changed since 2015).

This report is based on a review of academic articles and grey literature from international institutes and multilateral organisations. Most of the literature is gender blind, but there is a limited number of specific literature with a focus on the impact of investment contracts on women and gender relations.

2. State-Investor Contracts

What are they?

A State-Investor Contract is an agreement between the State (or an entity representing the State) where an investment will take place (host state), and the business investor or investors.[1] These contracts underpin investment projects in a number of industry sectors, such as agriculture, infrastructure, energy, oil, gas or mining. Such foreign investment contracts are not to be confused with Bilateral Investment Treaties (BITs), which are concluded between two or more States to regulate establishment and treatment of investment by nationals of one State in the territory of the other State(s).

These contracts, along with domestic law and any applicable international investment agreement, set out the rights and responsibilities of both the State and the investor regarding the development, construction and operation of an investment project. They also establish rules that govern how the parties should resolve any disputes that arise (e.g. Lester, 2015; Johnson & Volkov, 2013). These contracts allocate responsibility for managing risks in the project, including financial and non-financial risks, and also set out the fiscal arrangements for the project.

These contracts can be called by several names such as “Host Government Agreements”, “Host Country Agreements”, or just “Investment Agreement”.[2] There are different types of such contracts, including:

- **Concession Agreements**: Under a concession, a government or a state-owned entity awards a private party (the concessionaire) the exclusive right to use or exploit state-owned assets or to develop new ones, for the life of the concession. In return, the concessionaire is responsible for making investments and developing new infrastructure. The concessionaire is often remunerated based on regulated tariffs charged to end users, for the term of the concession, giving investors a long-term view of the project's revenue streams (e.g. Madalena, 2017).
- **Production Sharing Agreements (PSA)**: These contracts are commonly used in the petroleum sector and concluded between the investor and the host State or a state-owned oil corporation (in which oil ownership is vested). The investor participates in activities through providing financial and technical services to the state-owned

[1] This definition comes from the London School of Economics (LSE) Investment and Human Rights Project in the section of State-Investor Contracts: http://blogs.lse.ac.uk/investment-and-human-rights/connections/regulating-investment/state-investor-contracts/

[2] Idem. (LSE Investment and Human Rights Project.)

corporation (e.g. funds exploration, development and production). In return, it receives a share of oil/gas to recover costs and make a profit (e.g. Ahmadov et al., 2012).

- **Build-Operate-and-Transfer (BOT) Agreements**: These agreements concern the construction of infrastructure like airports, ports, dams, power plants and water supply systems. The investor undertakes the construction and financing of the infrastructure, and operates and maintains it for an agreed period of time. During such period, the investor can charge tolls, fees and other charges for the use of the infrastructure. At the end of the agreed period, the facility is handed over to the government. BOT contracts are often used in Public Private Partnerships (Liu, 2015).

Through these contracts, the parties may effectively agree a large part of the legal framework that will govern the investment, particularly where domestic legislation in the host State is under-developed, or where the project is in a nascent industry in the host State.[3] In these cases, the negotiation between the parties may directly influence the applicable legal framework for the project.

Most foreign investment contracts are negotiated behind closed doors, and are not accessible to members of the public even after they are signed. Such contracts are essentially the law of a public resource project, and laws shall be publicly available for democratic accountability (Rosenblum & Maples, 2009, p.15). The lack of transparency undermines the ability of individuals and groups affected by the investment project to have a say on whether and under what conditions the project should be undertaken. This lack of transparency also contrasts with the principles of public participation in decision-making as many investment projects (e.g. land investment, extractive industry investment) directly affect the lives, livelihoods and living conditions of surrounding populations (Rosenblum & Maples, 2009, p.16). Furthermore, disputes between foreign investors and governments are typically resolved through international commercial arbitration, which takes place behind closed doors (Lester, 2015).

The content of State-Investor Contracts

Although State-Investor Contracts vary in content, they generally contain the following sections:

Stabilisation clauses: There is an extensive amount of literature covering stabilisation clauses in investment agreements. Investors seek for the inclusion of clauses in the contract that protect directly again changes in law, to manage “non-commercial risks” (e.g. the expropriation of foreign investment projects through government action).[4] Stabilisation clauses, therefore, restrict the

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[3] Idem. (LSE Investment and Human Rights Project.)

[4] An example is the Production Sharing Agreement with respect of Block 1 of the Democratic Republic of Congo Albert Graben between the Democratic Republic of Congo and Divine Inspiration Consortium Group (Pty) Ltd (21 January 2008) art 28 (cited from Sotonye, 2014, p.27): “it has been understood however that each entity making up the “Contracting Party” could benefit from any favourable measure with respect to the regime defined above.’ Some formulations go even further to give investors the choice to switch back and forth between current laws and the stabilised laws according to the regime that they consider to be more beneficial. In other words, investors can elect to be bound by new laws where such laws are beneficial. However, where such laws are later amended and are no longer beneficial, they can switch back to the stabilised legal regime. For example, a 1995 Azerbaijan investment law exempts foreign investors from adverse changes in its laws but went further to provide that investors may: “at any time elect to be governed by the legal and regulatory provisions resulting from changes made at any time in the Law as in effect on the Effective Date. Provided further legislation of the Azerbaijan Republic deteriorates conditions of investment depositing, the legislation in force at the moment of investment is applied for the period, specified in the contract about investment activity”. (Sotonye, 2014, p.27-28).

host government not to alter the regulatory framework governing the project, by legislation or any other means, without the consent of the other contracting party; or, if it does so, to restore the economic equilibrium of the project or pay compensation (Sotonye, 2014, p.28). In many cases, such clauses are reinforced by provisions of BITs ("umbrella clause"). In such circumstances, the breach of stabilisation clause would inherently lead to a breach of BIT ensuring that monetary compensation are more certain to be awarded and are likely to be higher (Singh, 2015, p.12).

Stabilisation clauses are largely confined to investment projects in low- and middle-income countries, particularly in large natural resources, energy and infrastructure projects, where high fixed costs require large capital injections in the early stages of the project and with long timeframes before the project becomes profitable (Sotonye, 2014; Singh, 2015). Why these countries are more likely to include such clauses is due to a combination of investors' lack of confidence in the legal system, the desire of these countries to attract foreign investment, and their weaker negotiating power (Sotonye, 2014, p.55).

Stabilisation clauses are also associated with the use of financing techniques whereby creditworthiness and debt security are based, not on the investor's overall assets but, on the revenue expected to be generated by the investment project ("project finance"). As debt repayment depends on the materialisation of projected cash flow, project finance operations typically involve contractual arrangements, such as stabilisation clauses, to minimise risk and distribute it among the entities involved in the investment project (Hoffman, 2007).

Stabilisation clauses arrangements and stabilising commitments on specific issues, such as clauses stabilising the fiscal regime, or clauses stabilising regulation of the tariff structure in public utility projects. Clauses included are (Sotonye, 2014):

- **"Intangibility" clauses**, which state that the contract can only be modified with the consent of the parties, and/or which explicitly commit the government not to nationalise the investment;
- **"Freezing" clauses**, whereby the applicable domestic law for the contract is frozen in time as the law in force at the date of the conclusion of the contract, and the contract is not affected by subsequent legislation inconsistent with that initial body of law;[5]
- **Economic equilibrium clauses**, which link alterations of the terms of the contract to renegotiation of the contract in order to restore its original economic balance, or to payment of compensation.
- **Hybrid clauses**, Hybrid clauses are so named because they combine some characteristics of freezing and economic equilibrium clauses. A freezing clause becomes a hybrid clause if it goes further to provide that in the event that the changes in the law are made applicable to investors, the investors will be restored to the same economic position that they were prior to the changes. Similarly, an economic equilibrium clause becomes a hybrid clause if it includes exemption from the changes in the law (freezing technique) as one of the options that may be applied to restore the economic equilibrium.

[5] Example of a full freezing clause can be cited from a 2008 Production Sharing Contract providing that: "...the "DRC" guaranties to the "Contracting Party" throughout the duration of this Contract the stability of the general legal, financial, petroleum, tax, customs and economic conditions under which each entity exercises its activities, as such condition results from the legislation and regulation in force at the date of the signature of the Contract." (cited from Sotonye, 2014, p.19).

Dispute settlement: There is also an extensive literature that focuses on dispute settlement provisions in investment agreements. Foreign investors have rights to compensation from host states if their contractual rights are breached, which is typically not available to domestic businesses (e.g. Lester, 2015; Johnson & Volkov, 2013). When disputes arise between foreign investors and the countries that host them, foreign investment contracts usually say that they should be resolved through international arbitration and not national courts. International arbitration takes place behind closed doors. While only an investor can bring a claim for breach of an investment treaty obligation, either the investor or the government can bring a claim under commercial arbitration for breach of a contractual obligation (Cordes et al., 2016, p.16).

Taxation provisions: There is a separate debate going on in the literature about how international corporations arrange secret tax deals within their investment agreements with host country governments. This economic debate about taxation provisions in investment contracts focusses on the agreed corporate income tax rates and other tax provisions (e.g. tax holidays, tax on important input imports, income tax for foreign managers) that the international corporation pays to the government (IMF, 2015).

Other important clauses, but less discussed in the literature, are (IIED, 2005, p.5):

- **Choice of law clauses**: The effect of stabilisation clauses can be reinforced by clauses that define which system of laws governs the project. These clauses may state that the law of the host state is to apply with the exception of specified pieces of legislation.
- **Local content requirements**: Host states may be concerned to maximise input to the investment project through locally produced goods and services, whereas foreign investors may seek to maximise their freedom to source goods and services, or hire workers, from whatever sources they see fit.
- **Property rights-related provisions:** Foreign investment contracts address property and land rights, in particular for investment in agricultural and extractive sectors.
- **Applicable standards clauses**: Investment contracts contain clauses setting out the range of standards, other than those of the host state, that are to govern the project.

The trends

State-Investor Contracts are part of a larger spectrum of arrangements that together forms the investment regime. As was mentioned above, such contracts form together the restrictions (e.g. ownership and control, operational restriction, authorisation and reporting) and the standard of treatment and protection (e.g. treatment, transfer of funds, dispute settlement), which can be achieved through national law and policies, State-Investor Contracts, and International Investment Agreements (IIAs). The hierarchy can be describes as:[6]

- National laws, regulations and investment codes;
- State-Investor Contracts;
- Bilateral Investment Treaties (BITs);
- Double Taxation Agreements (DTAs);

[6] From the presentation of Marie-Estelle Rey (OECD Policy Analyst) titled “Trends in international investment rulemaking and Investor-State Dispute settlement”: https://www.oecd.org/mena/competitiveness/45727836.pdf

- Preferential Trade and Investment Agreements (e.g. EPAs);
- Regional (e.g. OECD) and Sectoral Agreements (e.g. Energy Charter);
- Multilateral Agreements (e.g. WTO GATS).

If a foreign investor is based in a country that has no BIT or DTA with the host country, the State-Investor Contract cannot refer to provisions in these bilateral deals, and the investor will seek more certainties from the host state. The trend is that on the international level the cumulative amount of BITs has reached its tipping point on 3322 in total in 2017 (UNCTAD, 2018),[7] and the estimation is that there are around 3,000 DTAs in force, increasing significantly since the early 2000s (Hearson, 2016).[8] Not only between advanced economies and developing countries, as South-South cooperation on international investment policy is intensifying, with India, China and Brazil making their own agreements with developing countries. Also, international investment rules are increasingly being formulated as part of trade agreements that encompass a broader range of issues, resulting in increasingly sophisticated and complex investment rules (Lester, 2015). Increasing activity in international investment treaty-making has been paralleled by a rise in investor-State disputes.[9]

3. The spill-over effects of foreign investment

Because of the secret nature of State-Investor Contracts, there is hardly any empirical evidence on the impact of such contracts on development in the literature. Most research on the impact of investment agreements, focuses on the evidence of the legal consequences of IIAs by signing BITs. It does so by looking at the content of BIT templates and by searching for international arbitration cases. Such studies mainly relate to the discussions on the impact of stabilisation and dispute settlement clauses. Other literature has a more general look at the impact of foreign investment (mainly Foreign Direct Investment) to explain positive and negative spill-overs for development. This section of the report gives an overview of the evidence available for the latest, while the next section will look more in detail to the implications of some of some clauses.

FDI and economic growth

FDI delivers a number of important contributions to economic development in terms of investment, employment, and foreign exchange. However, it is FDI's spill-over potential (the productivity gain resulting from the diffusion of knowledge and technology from foreign investors to local firms and workers) that is its most valuable input to long-run growth and development (Farole & Winkler, 2014, p.1). The empirical literature seems to agree that any positive effect of FDI on growth is largest among developed countries, since they have the absorptive capacity to benefit from the foreign investment (Bermejo Carbonell & Werner, 2018, p.426). Herzer (2012)

[7] Investment treaty making has reached a turning point. The number of new IIAs concluded in 2017 was the lowest since 1983. For the first time, the number of effective treaty terminations outpaced the number of new IIAs (UNCTAD, 2018, p.2)

[8] For more information on DTAs, see the K4D Helpdesk report: Quak, E. & Timmis, H. (2018). Double Taxation Agreements and Developing Countries. K4D Helpdesk Report 308. Brighton, UK. Institute of Development Studies. https://opendocs.ids.ac.uk/opendocs/handle/123456789/13839

[9] From the presentation of Marie-Estelle Rey (OECD Policy Analyst) titled "Trends in international investment rulemaking and Investor-State Dispute settlement": https://www.oecd.org/mena/competitiveness/45727836.pdf

analyses the effect of FDI on economic growth in forty-four developing countries, adopting the GETS methodology to identify country-specific factors (e.g. primary export dependence), and reports a negative effect on growth but also large cross-country differences.

The overall belief that FDI is good for economic growth and capital accumulation rather comes from hypothesis in theory than the evidence shows. In macroeconomic theory FDI helps host countries integrate into the world economy, as foreign firms are engaged in exporting and use their global sales and supply networks, and, thus, stimulates trade in the long run. And the theory shows that FDI results in more competition, leading to lower prices, more efficient resource allocation, and higher aggregate productivity (OECD, 2002). At the microeconomic level, the theory shows that FDI can benefit local suppliers directly through increased demand for intermediates, thus raising their output, profits, and possibly investments and labour demand. FDI can also give local producers access to cheaper, higher quality, and more reliable inputs (Farole & Winkler, 2014, p.9). Specific for developing countries, the theory shows that as diminishing returns to capital, and a lower capital stock in developing countries are assumed, returns on capital should be higher in developing countries, enticing international capital from rich to poor countries, helping the latter catch up. This narrative provides theoretical support for developing countries to utilise FDI.

However, empirical evidence has suggested otherwise: long-run growth is empirically due to technical progress, not capital or investment and capital was found not to flow from rich to poor countries, but rather from poor countries to the rich (Gourinchas & Jeanne, 2013). Evidence also shows that FDIs have contributed to a rise in imports as well as exports of developing countries. FDI tends to lead to an upsurge in imports, which can only be gradually reduced after local companies acquire the skills to serve as subcontractors to the entrant corporation (OECD, 2002).[10] Also, the literature shows that there is evidence that positive effects of FDI are for a large part mitigated by a “crowding out” of domestic investment.[11] What is less clear from the

[10] “The clearest examples of FDI boosting exports are found where inward investment helps host countries that had been financially constrained make use either of their resource endowment (e.g. foreign investment in mineral extraction) or their geographical location (e.g. investment in some transition economies). Targeted measures to harness the benefits of FDI for integrating host economies more closely into international trade flows, notably by establishing export-processing zones (EPZs), have attracted increasing attention. In many cases they have contributed to a raising of imports as well as exports of developing countries. However, it is not clear whether the benefits to the domestic economy justify drawbacks such as the cost to the public purse of maintaining EPZs or the risks of creating an uneven playing field between domestic and foreign enterprises and of triggering international bidding wars” (source: OECD, 2002, p.12).

[11] “Empirical studies controlling for different structures of foreign ownership tend to support the more positive spillover effects of JVs [Joint Ventures]. For example, Havranek and Irsova (2011) find evidence for lower spillovers in fully owned foreign affiliates, and Javorcik (2004a) and Javorcik and Spatareanu (2008) find a positive vertical spillover effect on domestic firms in supplying industries from multinationals with partial foreign ownership, but not from multinationals with full foreign ownership. Abraham, Konings, and Slootmaekers (2010) find for a sample of Chinese manufacturing firms that foreign ownership in a domestic firm’s sector only results in positive horizontal spillovers when foreign ownership is organized as a JV. By contrast, the presence of fully owned foreign firms is found to have a negative impact on local firms, due to the technology intensity of multinationals crowding out local producers within the same sectors (Abraham, Konings, and Slootmaekers 2010) (source: Farole & Winkler, 2014, p.31). Another way of “crowding-out” relates to the access to domestic finance. “[I]f multinationals borrow from local financial institutions, they may increase local firms’ financing constraints (Harrison, Love, and McMillan, 2004). This, in turn, can influence a local firm’s absorptive capacity. Harrison, Love, and McMillan (2004) find evidence for the second effect using firm-level data for a cross-section of 38 high- and low-income countries. In this context, some countries have in the past attempted to limit access to local financial institutions for FDI firms in order to not crowd out scarce funds for domestic investments (source: Farole & Winkler, 2014, p.44).

literature is whether FDI is inherently more important than alternative types of investment, specifically domestic investment. Rodrik (2003) states that “[o]ne dollar of FDI is worth no more (and no less) a dollar of any other kind of investment” (cited in Farole & Winkler, 2014, p.9). Some studies even find that the net contribution of FDI to economic growth is lower than that of domestic investment (e.g. Tang et al, 2008, for China).

In the Low-Income Countries (LICs), FDI seems to have a smaller effect on growth, which has been attributed to the presence of “threshold externalities”. Developing countries need to have reached a certain level of development in education, technology, infrastructure and health, which need increased public investment, before being able to benefit from a foreign presence in their markets (OECD, 2002; Bermejo Carbonell & Werner, 2018). Imperfect and underdeveloped financial markets may also prevent a country from reaping the full benefits of FDI. Weak financial intermediation hits domestic enterprises much harder than it does international corporations. In some cases it may lead to a scarcity of financial resources that precludes them from seizing the business opportunities arising from the foreign presence (OECD, 2002; Bermejo Carbonell & Werner, 2018).

Horizontal and vertical spill-overs

Economic literature identifies technology and knowledge transfers as the most important channel through which foreign corporate presence may produce positive externalities in the host developing economy. The use of higher levels of technologies and knowledge by international corporations generates technological horizontal and vertical spill-overs (e.g. on labour markets), where the first refers to other businesses in the same sector, while the latter refers to the impact on suppliers and clients of international corporations. For example, Havranek and Irsova (2011) take into account 3,626 estimates from 55 studies on vertical spill-overs. They find evidence for positive and economically important backward spill-overs from multinationals on local suppliers in upstream sectors and smaller positive effects on local customers in downstream sectors. However, the authors reject the existence of horizontal FDI spill-overs. This can be explained with international corporations avoiding spill-overs of knowhow and technology to their immediate competition.

The case study literature on FDI spill-overs complements the econometric studies by providing more detail on the mechanics by which spill-overs occur. This literature is also mixed, but shows some positive outcomes not only for vertical linkages but also through horizontal intra-industry linkages in cases where such investment is embedded in a broader institutional and entrepreneurial ecosystem (Farole & Winkler, 2014, p.11). Overall, it can be concluded that while substantial empirical evidence has been amassed over the past decade on the existence and dynamics of FDI spill-overs, the results are very mixed (and mostly overlooking sub-Saharan Africa with research mainly in South East Asia and larger emerging markets, like Mexico and India); simply attracting FDI by no means guarantees that a country will benefit from spill-overs (Farole & Winkler, 2014, p.7). This highlights the importance of understanding more clearly the conditions under which FDI can lead to positive spill-overs and how governments could use that for State-Investor Contracts.

How important the absorption level of countries is to fully benefit from spill-overs, show the following examples (OECD, 2002):

- For **technology transfer** to generate externalities, the technologies need to be relevant to the host-country business sector beyond the company that receives them first.

Evidence suggests that where important differences prevail, or where the absolute technological level in the host country is low, local enterprises are unlikely to be able to absorb foreign technologies transferred via international corporations.

- The major impact of FDI on **human capital** in developing countries appears to be indirect, occurring not principally through the efforts of international corporations, but rather from government policies seeking to attract FDI via enhanced human capital. Thus, the issue of human capital development is intimately related with other, broader development issues.

More recent literature (then the extensive OECD report of 2002 on the impact of FDIs) comes to the same conclusions. Several studies find evidence that a country's level of institutional development significantly affects the extent of FDI spill-overs (Du et al., 2011).[12] However, little is still understood about the details; for example, understanding institutional factors at the national, sectoral, and international/regional level is critical to formulating government policies that will stimulate FDI-generated spill-overs (Farole & Winkler, 2014). Furthermore, Farole and Winkler (2014) emphasise how critical it is to understand how LICs' and LMICs', in particular in sub-Saharan Africa, specific institutional contexts and development concerns affect transmission channels. Other knowledge gaps are how vertical spill-overs relate to global value chains and how spill-over effects relate to other sectors than manufacturing (see box 1).

Box 1. Sector case studies from Africa*

Mining: While current linkages of foreign investment in mining in supply chains, labour markets, and wider networks remain limited, research shows that some progress is being made, and scope exists for achieving deeper local economy integration, and ultimately productivity-enhancing spill-overs. One example is mining in Ghana that shows that some African countries are making slow progress. However, improving the potential for spill-overs requires deep efforts in building supply-side capacity (most of which are not related directly to mining). It also requires an active, collaborative sectoral strategy, combined with a credible and efficient regulatory approach.

Agriculture: The supply chain, labour market, and other network linkages between foreign investors and the local economies are relatively higher in agriculture than in other value chains, driven by the fundamental requirement of sourcing domestic agricultural inputs. Sub-Saharan African countries appear to have less well-established linkages than developing countries in other regions, determined mainly by having less-sophisticated domestic firms as well as fewer commercial-scale farms. The increasing importance of global standards and certification appears to be a major catalyst for supporting knowledge transfer between foreign firms and domestic actors. Efforts to promote spill-overs, particularly through input provision, financing, and technical support, are extensive throughout most countries. However, their sustainability is less certain, underscoring the importance of complementary and cross-cutting policies to improve skills and address supply-side constraints to competitiveness in the sector.

Apparel: Kenya, Lesotho and Swaziland attracted FDI in apparel sector through building export processing zones and offering fiscal incentives. However, spill-overs are very limited with no locally owned apparel firms exporting or subcontracting, local value added remaining low, local participation in management remaining limited, and domestic suppliers absent in core and even most noncore inputs. The main constraints for spill-overs are the concentration of investment in low value–added activities, external control of sourcing, and reliance on

[12] "We find strong evidence that subsidized foreign investment generates greater productivity spillovers than unsubsidized firms. The magnitudes imply that a 1 percentage point increase in the share of foreign investors in downstream sectors raises the supplying firm's productivity by 2 to 3 percentage 29 points. The evidence also suggests that foreign firms put significant downward pressure on the prices of the supplying firms. Across our sample spanning a ten year period, vertical linkages accounted for an important source of productivity gains for all types of enterprises" (source; Du et al, 2011, p.28-29).

expatriates in managerial and technical positions. This is aggravated by a weak domestic absorptive capacity (weak skills development, non-existing or inadequate domestic training institutes), barriers in the domestic business climate, ineffective policies to support local small and medium enterprises, and a missing local entrepreneurial response.

* Source: Farole, T., Winkler, D. (2014). *Making Foreign Direct Investment Work for Sub-Saharan Africa.* World Bank. http://dx.doi.org/10.1596/978-1-4648-0126-6

4. The impact of State-Investor Contracts on development

Human rights

The literature identifies a "double-speed" globalisation, with rules governing trade, competition and investment becoming global norms, while health and environmental protection, social and labour rights are issues of international negotiation and domestic regulation. In State-Investor Contract this becomes visual as foreign investors use the global norms to protect them, while having the freedom to negotiate on domestic land rights, labour rights, health and safety standards, and environmental protection. These concerns attracted the attention of former UN Special Representative for Business and Human Rights, John Ruggie ('SRSG'), and the International Finance Corporation (IFC), the private sector lending arm of the World Bank. The SRSG and the IFC conducted a joint empirical study (2009) of the potential of stabilisation clauses to interfere with the ability of States to fulfil their international human rights obligations. After analysing 88 contracts and models from a cross-section of industrial sectors from all regions of the world, the study concluded – amongst other things – that stabilisation clauses in modern contracts are drafted in a manner that could negatively impact a host State's implementation of its human rights obligations. In particular, the study found that non-OECD countries are much more likely than OECD countries to include social and environmental laws (even laws of general application on issues such as minimum wage, labour, health, safety, etc.) in a stabilisation clause.[13] Ruggie (2009, p.32) has two reasons for this difference:

- Stabilisation practice correlates to the perception of investment risk in a given non-OECD country;
- There may be issues related to the legality of freezing clauses in OECD countries.

The Ruggie study ultimately resulted in the submission of the UN Principles for Responsible Contracts (2015) to the Human Rights Council. The ten principles provide guidance for a range of practitioners, including commercial and State negotiators, on integrating human rights risk management into State-Investor Contract negotiation. While the UN Principles for Responsible Contracts include guidance on stabilisation clauses, they also address a number of other issues

[13] About 59% of the contracts (44 of 75 contracts) in the Ruggie study (2009) from non-OECD countries give exemptions or offer an opportunity for compensation for compliance with all new laws, including environmental and social laws. None of the OECD country contracts in the study offer exemptions from new laws, while only 15% (2 contracts of the studied 13) of contracts and models from the OECD offer an opportunity to claim compensation for compliance with all new laws, including environmental and social laws. It is notable that 4 of the 11 sub-Saharan African contracts contain clauses freezing all laws (including environmental and social) – the highest of all regions, as most of the other regions opt for partial freezing clauses. The same goes for economic equilibrium clauses: eleven of 13 stabilisation clauses in the OECD contracts are limited economic equilibrium clauses (the narrowest form of stabilisation clauses in the study). In contrast, limited economic equilibrium clauses are relatively rare in the contracts of developing countries.

related to avoiding, mitigating and remediating human rights risks, such as community engagement, project monitoring and access to remedy by people impacted by projects (UN, 2015). It is part of the broader UN Guiding Principles on Business and Human Rights (2011) that sets out a framework for the State's obligation to protect human rights, the business' obligation to respect human rights, and the obligation of access to remedy (e.g. grievance systems) for local communities and individuals.

The adoption of global rules and norms like the UN Guiding Principles and the UN Principles for Responsible Contracts and the so-called 'new generation' investment policies (e.g. UNCTAD and OECD) play an important role in recognizing that human rights considerations and a sustainable development framework is crucial to foreign investment's success as a key driver of economic growth and job creation. However, this report could not find any literature with real evidence of a shift in the outcomes of State-Investor Contract negotiations. One study focussing on the right to water suggests that it is evident from some recent tribunal cases there is a greater weight to broader human rights dimensions - specifically the right to water - raised by governments in defence of what may otherwise be considered a straight treaty breach (Furragia, 2015, p.282). The important caveat to this trend, however, is that no tribunal has yet ruled on a direct conflict between human rights and investment agreement obligations: thus far, tribunals have been content with affirming the coexistence of both human rights law and investment obligations without any serious discussion of hierarchical conflict (Furragia, 2015, p. 282).

Gender

Investment agreements are mainly ignoring the consequences of such investments for the relationship between men and women. For example, one study on the gender effects of foreign agricultural investments shows that inequalities are often exacerbated by foreign agricultural investments, unless investors and host country governments work to ensure that investment contracts address the needs of women farmers and agricultural workers (Sexsmith, 2017, p.1). Negotiations are led by national governments, and include participation of local elites, agricultural producer groups, or individual farm owners with private title to land. These have implications for women's participation as they generally have no private titles and are not represented within producer groups (Sexsmith, 2017, p.20). When investments are negotiated at the group level, outcomes are not likely to be positive for women, considering that local governments, chiefs, and leadership among producer groups are more likely to be male, and gender inequalities may thus become further entrenched (Behrman et al., 2012). The fact of their more restricted land rights, coupled with the assumption by investors that women do not hold land at all, leads to women's exclusion from negotiations in land deals (Deninger et al., 2011).

The FAO (2013a) found that women made up only 5 to 15% of the members of three cooperatives involved in agribusiness deals with foreign investors, because they were not included equitably in a prior national agrarian reform programme. Hence their participation in group decision making around the deal itself was limited. When women are inadequately included in negotiations, gender-specific concerns are less likely to be heard and addressed. This appears to be the trend, considering that among the 39 investment projects reviewed by the World Bank and UNCTAD, only three had explicit gender policies (World Bank, 2014, p. 24–25). They observed a "striking" absence of women's concerns in the design and implementation of investment projects (World Bank, 2014, p. 25). This undermines development as research shows that barriers to women's access to productive resources - production inputs, credit and training - reduce female agricultural producers' yields by 20–30% from their full potential (FAO, 2011).

Further, culturally based gender discrimination often leaves women with a heavier burden for care work, diminishes their access to education, restricts their access to land and limits options for decent paid work (UNCTAD, 2015).

The type of contract influences the degree to which women are included equitably in negotiations. Behrman et al. (2012) observe that land concessions, production-sharing agreements, and joint ventures tend to vary in terms of transparency and direct community involvement in the negotiations process. One major concern with concession contracts is the serious lack of transparency in the process and the dearth of information that local populations have about the terms of the contract (GRAIN 2016). This lack of transparency may be particularly detrimental to poor rural women, who are already less informed of their rights and who have less mobility and correspondingly less access to outside information and alternative livelihoods (Behrman et al., 2012, p.9). In production-sharing agreements harvesting and sale are typically done centrally, and there is scope for manipulation of the share that goes to the local population, depending on how products are priced, in particular effecting women as they are mostly not head of the households (Behrman et al., 2012, p.9).

Although joint ventures are typically held to be the most equitable option because they are often made directly with community groups, it does not mean that they are necessarily gender equitable. Case studies on gender and land deals in Mozambique find that women are often left out of consultation and negotiation processes (Duvane, 2010). Tandon's (2010) work on large-scale investments on Maasai pastoral lands in Tanzania finds that poor farmers in general, and women in particular, are virtually excluded from political decisions regarding the land they use. Finally, two FAO case studies show the lack of women's participation in investment deals. In Ghana, the negotiation of a land lease for a nucleus estate for agro-export production largely excluded women, and they did not receive any direct compensation payments (FAO, 2013a). Women's participation was also limited in the negotiation of contract farming in the Lao People's Democratic Republic (FAO, 2013b).

Environmental governance

As the above part on human rights showed, governments in less developed countries are more likely to include stabilisation clauses with full freezing clauses and full economic equilibrium clauses, which impact directly on the further development of environmental governance as many foreign investment projects are long term contacts. Concessions can also be negotiated on the use of environmental standards and monitoring. However, Chung (2014) finds strong evidence that polluting industries tend to invest more in countries with laxer environmental regulations in terms of both the amount of investment (intensive margin) and the number of new foreign affiliates (extensive margin). A study from China indicates that in the low discharge regulation and low emission standard regulation industry, labour-based FDI has a significant negative spill-over effect, and capital-based FDI has a significant positive spill-over effect on introducing greener technology (Hu, 2018). However, in the high-intensity environmental regulation industry, the negative influence of labour-based FDI is completely restrained, and capital-based FDI continues to play a significant positive green technological spill-over effect (Hu, 2018). These findings have clear policy implications for the Chinese context: the government should be gradually reducing the labour-based FDI inflow or increasing stringency of environmental regulation in order to reduce or eliminate the negative spill-over effect of the labour-based FDI.

Evidence from sub-Saharan Africa is sparse. There is the assumption that the best environmental policy for Africa is to encourage inflows of multinational firms that abide by global technology standards, which in a way can facilitate domestic energy efficiency, thereby reducing pollution emissions (Aliyu & Ismail, 2015). However, there are concerns about FDI from China and other emerging countries (Marsh, 2015). And as already concluded above in the section on the economic spill-overs, absorption levels are important, with strict regulations and monitoring acquired. Therefore, rules on the legality and effect of stabilisation clauses are so important as it can have important implications for the ability of governments to adopt regulatory measures for pursuing environmental goals. Where regulation in pursuit of such goals has the effect of raising the costs of an ongoing investment project (for instance, due to tighter requirements on environmental pollution), it has the potential to fall within the scope of stabilisation clauses found in individual investment contracts. As a result, a host State that adopts regulation raising environmental standards and that seeks to apply such standards to ongoing investment projects would have to compensate investors for the economic impact of that regulation.

This may make it more difficult for host states – particularly poorer ones – to raise the regulatory standards applicable to investment projects. Alternatively, host states may seek to exclude ongoing investment projects from the application of new regulations. In this context, the operation of stabilisation clauses may in the worst cases lead to continued application of low standards for decades to come. Stabilisation clauses may also create distortions in legal policy, with host states favouring ways to pursue environmental goals that are less costly for ongoing investment projects – even if they are less effective in pursuing those goals. However, this is not backed with strong evidence in the literature as it is difficult to measure these changes.

Land issues

Governments in developing countries make investment deals with foreign investors on land rights, in particular in agriculture, tourism and extractive industries (Zoomers, 2010). Natural resource concessions would normally cover land concessions or leases. To induce investors to purchase/lease their land, governments offer extensive tax breaks for foreign corporations, sell/lease the land at below-market prices and even go as far as to clear their own citizens from the land to make room for large-scale plantations (Mousseau & Mittal, 2011a; Mousseau & Mittal, 2011b; Mousseau & Sosnoff, 2011). For example, Ethiopian law requires the use of environmental impact assessments in consultation with local affected tribes. The laws are poorly enforced, however. There is no evidence of tribal consultations, nor of completed environmental assessments and no domestic environmental controls. The government has used the military to force tribal groups off their land, displacing them again and again to make room for foreign investors (Mittal 2013).

As such land deals between governments and foreign investors' impacts on the property and land rights of local people. Where foreign investors holding land rights could often be entitled to the treatment provided by BITs – and also by other relevant treaties, by virtue of any applicable most-favoured-nation clause. Being covered with a BIT the foreign investor can establish more stringent requirements than national law and international human rights law. They would also be entitled to bring land-related investment disputes with the host state to investor-state arbitration (Cotula, 2015, p.13).

Land reform issues (e.g. redistribution, restitution, land occupation by local communities) that could arise in investor-state arbitration, may result in high payment of compensation for the foreign investor at specified standards (Thresher et al., 2015). Hence, investment agreements can make it more costly for states to take action. As a result, concerns have been raised that investment protection risks crystallising historical injustices, particularly in low- and middle-income countries where public finances may face harder constraints (Peterson & Garland, 2010; Vervest & Feodoroff, 2015). And where governments do not wish to implement land reform due to the interplay of vested interests and power relations, investment agreements could provide governments with legal arguments to legitimise political choices.

Evidence on the benefits and disadvantages of specific land deals is very mixed depending again very much on the institutional level and absorption level to create positive spill-overs (Zoomers, 2010). What the literature on investment agreements shows is the importance of engagement of local communities, remedy and grievance mechanisms (Cordes et al., 2016), including access to compensations – even in the absence of legal land rights (Cotula, 2015). This is more important, because foreign investors can rely on international norms and international commercial arbitration, while local people rely on often underfunded and not often political independent domestic juridical systems (this is not only the case for land rights, but also for right to water, or by seeking compensation for pollution due to an investment project).

Looking at the compensation for foreign investors, investment agreements mention a compensation at market value, which usually includes loss of projected future profits as well as sunk investments. This exclusive emphasis on market value contrasts with the approach taken in some national constitutions. In Europe, for example, the right-to-property jurisprudence of the European Court of Human Rights is centred on the notion of a “fair balance” that must be struck between individual and collective interests. Compensation is but one important factor in this assessment. As a result, while compensation must be “reasonably related” to market value, it can be less than market value, provided that the overall balance struck is fair (Cotula, 2015). In addition, the nature of the public purpose pursued may be taken into account when determining compensation, potentially justifying compensation below market value.

For developing countries the inclusion of “fair balance” is not the case. As a result, investment agreements can require higher compensation than would be applicable under national constitutions. Many investment agreements also require compensation to be paid “without delay” and with interest, and to be “effectively realizable and freely transferable”. As such, compensation requirements may prove particularly onerous in large-scale agrarian reforms, which may involve the expropriation of many properties (Peterson & Garland, 2010). The topic is particularly important, because (Thresher et al., 2015):

- The very large number of land deals signed in a relatively short time, in particular related to agriculture, extractive industries, tourism and energy sectors (www.landmatrix.org);
- The poor quality of at least some of the investor-state contracts underpinning the deals, leaving much room for diverging interpretations and renegotiation;
- Evidence suggesting that an unquantified but potentially significant share of large-scale land deals is protected by investment treaties;
- The fact that many deals concern countries where land governance is weak, so public authorities may lack the capacity to act in ways that comply with investment treaties.

In most African countries, only a tiny proportion of rural land is formally registered or titled. Most African farmers gain access to land through customary rights, which are rarely adequately protected by national legal systems. This exacerbates the likelihood that efforts physically to ‘clear the way’ for foreign investment or guarantee free access to foreign investors through foreign investment contracts will cause hardship for local people.

Taxation[14]

One of the main instruments governments have to attract foreign investors is to give them special tax provisions. The literature shows a sharp fall in statutory corporate income tax rate. Abramovsky et al. (2014, p.568) in their sample of 41 low and middle-income countries (Latin America, Africa, Europe and Asia) measured a fall from 31% in 1996 to 26% in 2010. Studies found that corporate income tax rates fell by more in smaller developing countries than in larger ones (e.g. Abramovsky et al., 2014; IMF 2014) as they feel the pressure to reduce tax rates (Abbas & Klemm, 2013, p. 596). Statutory rates of corporation tax are a good indicator to signal tax competition, however, the literature shows that they are unreliable to the levels of corporate tax actually being paid. Moves in negotiations of State-Investor Contracts to reduce corporate taxes, through tax breaks, tax holidays, and aggressive tax planning strategies could result in far lower real and effective rates (e.g. IMF, 2015).

However, developing countries are more dependent on corporate tax revenues than high income countries, measured as a proportion of total tax revenues, which means that their overall fiscal performance is more vulnerable to pressures on these receipts by tax competition (IMF, 2014, p.7). In 2017 approximately 14% of total tax revenue came from corporate income tax, with Nigeria, Cameroon and Mozambique having the largest share of corporate income tax (ATAF, 2017, p.32). Furthermore, most countries in Africa rely heavily on tax revenue from a small number of multinational corporations. A small number of large taxpayers account for over 50% of the total revenue of Zambia, Swaziland, Nigeria, Mozambique, Liberia and Burundi (ATAF, 2017, p.87).

The result, and in contrast to high income countries, most developing countries (LICs and LMICs) in the sample of Abramovsky et al. made tax bases narrower, showing that they were not able to compensate for the revenue loss. Moreover, tax bases became narrower between 1996 and 2007, particularly in sub-Saharan Africa (Abbas & Klemm, 2013, p.602). Both Crivelli et al. (2015, p.23) and Cobham at al. (2018, p.220) show that countries in sub-Saharan Africa suffer the highest revenue losses compared to GDP followed by, Latin America and the Caribbean, and South Asia. Both also show that the group of LICs suffer the highest loss compared to their GDP.

Crivelli et al. (2015, p.23), concludes that developing countries, in particular in sub-Saharan Africa, face harmful tax competition. They also suggest that there are signs that the narrowing of the tax base may operate less through effects on real investment decisions than through profit-shifting by the international corporations.[15] A firm may decide to locate in a country which levies a relatively high effective average tax rate, but at the same time grants extensive opportunities to shift profits to other, low tax locations (for instance in the form of weak transfer pricing regulations) (Munongo et al., 2017, p.165).

[14] Most of the information in this section comes from the K4D Helpdesk report on tax competition: Quak, E. (2018). The impact of international tax competition on low- and middle-income countries. K4D Helpdesk Report no. 324. Brighton, UK: Institute of Development Studies.

[15] The revenue losses through tax avoidance activities are associated with tax havens and the research suggest they are of more concern for non-OECD members; the estimates put them in the order of over 1% of GDP in the long run, and harder for them to replace from other sources (Crivelli et al., 2015, p.23).

The literature also shows that tax holidays, especially popular in developing countries, tend to favour readily mobile ('footloose') activities rather than long-term investment (IMF, 2015, p.20).[16] In conclusion, tax incentives for LICs could be counter-productive for long term development goals. Evidence for 40 Latin American, Caribbean and African countries between 1985 and 2004 suggests that changes in the length of tax holidays systematically increased FDI inflows. These FDI inflows did not, however, increase total investment, nor did they increase economic growth. This finding suggests full displacement of domestic by foreign capital (Klemm & Van Parys, 2012, p.412). There is a consensus growing that governments must be careful with tax incentives for the reason to attract foreign investors (IMF, 2015).

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[16] "By offering temporary tax relief for profitable firms, tax holidays benefit industries that start making profits soon in the holiday period. This introduces a bias towards short-term projects with low upfront investment costs, which may be those least likely to generate spillover effects on the wider economy (of the kinds described above). Such investment projects are known to "pack and go", fleeing the host country as soon as the preferential treatment is removed. For industries with significant long-term capital needs, and for which spillover benefits may be greater, tax holidays could actually discourage investment: little otherwise taxable profit might be expected during the holiday period, and, to utilize depreciation allowances, a firm might be encouraged to postpone investment until after the holiday period in order to claim full deductions for its costs (see background document)." (Source: IMF, 2015, p.20).

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About this report

This report is based on five days of desk-based research. The K4D research helpdesk provides rapid syntheses of a selection of recent relevant literature and international expert thinking in response to specific questions relating to international development. For any enquiries, contact helpdesk@k4d.info.