

RECENT TRENDS IN THE INCIDENCE OF PERFORMANCE REQUIREMENTS IN CONTEXT OF IIAs

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ABSTRACT

Performance Requirements (“PRs”) refer to certain obligations imposed by host states on investor states in international investment agreements while conducting business with them. These PRs have been prohibited in the Bilateral Investment Treaties (“BITs”), which has remained the question of concern in today’s international investment world. Provisions in PRs required mandatory use of domestic materials, compulsory hiring of domestic personnel, and obligation to export some amount of products. Prohibition on Performance Requirements (“PPRs”) reverses the practice of obligation to abide by performance requirements. They have become popular today because PRs are considered to be in contravention with the concept of liberal markets. Earlier, there was no prohibition on performance requirements, then, came TRIMs agreement which bound WTO members to not impose two types of performance requirements. One was the requirement of the domestic content and other was various requirements on export. Outside WTO, there is a broad scope of prohibitions on performance requirements inspired by NAFTA in IIAs.

PRs have remained controversial in the sense that some feel that they act as an effective tool for the development and appreciation of the host state and others feel that they are undesirable for the operation of liberal markets. This can be seen in the clause in treaty between US and Cameroon which specifies that “Neither Party shall impose performance requirements as a condition of establishment, expansion or maintenance of investments owned by nationals or companies of the other party, which require or enforce commitments to export goods produced, or which specify that goods or services must be purchased locally, or which impose any other similar requirements.”¹

Keywords: Performance requirements, Prohibitions, TRIMS, NAFTA, Treaties.

¹ RUDOLF DOLZER AND CHRISTOPH SCHREUER, PRINCIPLES OF INTERNATIONAL INVESTMENT LAW 82 (2008)

PERFORMANCE REQUIREMENTS

In layman term, we can define PRs as certain requirements which investor states are bound to fulfill while doing business with the host state. PRs are imposed on the entry or further expansion of the foreign investment in the host country with an intention of squeezing out some benefits from those FDIs. An essential effort was made by UNCTAD in defining PRs as “stipulations, imposed on investors, requiring them to meet certain specified goals with respect to their operations in the host state and which may cover all aspects of the investment”.² The objectives of using PRs are mainly promotions of the linkages, technology transfer, creating employment opportunities, making the industrial base strong, increasing domestic value added, and distribution of political power, trade balancing, avoiding restrictive trade practices, export performance, distribution of rent and various other non-economic objectives such as political independence.

PRs are majorly used by developing countries. It was felt that imposing PRs will prove more beneficial and effective for host states compared to foreign investors and for this reason PRs of the host states ensured that profits made by them is more than foreign investors whereas from the perspective of developed states, it was felt that PRs distort international trade as they are in contravention to national treatment because they do not offer equal treatment to foreign investors and domestic people.³ However, this does not imply that developed countries have completely given up on restricting FDI Policies. They have instead started using different instruments to impose performance requirements. For example, members of EU and NAFTA use rules of origin to take advantage of regional trading area as an exception under Section XXIV of the GATT. It sets a limit on foreign investors to use specific amount of domestic content in their products so as to make it as an internal product of the regional area. This practice is somewhat similar to “local content requirements”.⁴ Another instance of PRs from developed countries is “Buy American Act”. A Hungarian manufacturer of buses had to use US made engines, axles and transmission in

² UNCTAD p.2, (2003)

³ M. SORNARAJAH, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT 205 (2010)

⁴ United Nations Conference on Trade and Development, *Foreign Direct Investment and Performance Requirements: New Evidence from Selected Countries*, p. 12 (Oct., 2003)

order to qualify their product as a domestic product of US so that they can claim 25 per cent price preference under Buy American Act.⁵

PRs can be categorized into three different types.⁶ First one is mandatory PRs vs. non-mandatory PRs. Mandatory PRs are those conditions which investing parties have to essentially fulfill in order to make an entry or continue their operations in the host state. On the other hand, non-mandatory PRs are the advantage based PRs.⁷ Investors are given certain incentives to comply with requirements which may include supply service or provide employment opportunities in its territory. Incentives may include giving certain tax exemptions or fiscal exemptions. More specifically, an investor country may be given tax or fiscal exemptions if they comply with requirements like providing its services in its territory. But these requirements are not mandatory to fulfill. Investors may opt not to fulfill any of these requirements in exchange of which, they will not get any incentives.

Second classification is based on the point on which PR is imposed i.e. whether it is imposed before the investment is made or after the investment is made. PRs imposed before investment is made relates to conditions imposed on entry, acquisition or establishment of the investment of the investor country. PRs imposed after the investment is made related to management or operation condition which investor countries have to fulfill after an investment is made in the host country.

Final classification is PRs covered by national legislation v. PRs covered by investment contract.⁸

REASONS FOR DECLINING INCIDENCE OF PRs

Misuse of Performance Requirements

PRs often act as barriers in the free flow of FDIs. They work efficiently for economic and industrial development of host as well as investor state until they are misused and start becoming detrimental to the effective operation of liberal markets. They act as investment disincentives when they start going against the best interests of the investor country. There are many statistics that

⁵ *Id*

⁶ SUZY H. NIKIEMA, PERFORMANCE REQUIREMENTS IN INVESTMENT TREATIES BEST PRACTICE SERIES 2 (2014)

⁷ *Id*

⁸ *id*

show inefficiency and failures of PRs, however, it is not that they are poor tools of investment but it is the manner in which they are used that makes them inefficient. It is important for the countries using PRs to avoid such pitfalls in order to make them effective tools in IIAs. They should be used in such a way that presents their fair view and which produce effective results for both the parties without causing damage to economic viability of investments.

Increasing Competition

Decreasing trade barriers and increasing competition in trade has forced host countries to abandon measures including the mandatory use of performance requirements. If they still do so, it may result in decreasing FDIs and may hinder their competitive capacity. Host countries are now resisting from imposing mandatory requirements in the areas where they have weak bargaining position. Instead of mandatory PRs, countries have started using incentive based requirements where they induce investor countries to operate in a manner which may result in the development which host country desires.

Authority regulations

Government of many countries is now giving preference to more market friendly tools for development. WTO rules are also one of the reasons for the declining incidence of PRs. They prohibit their members to adopt such measures.

It is important to keep a check on the operation of PRs. Under developed capacity of R&D also results in limited success of PRs because R&D plays a crucial role in developing and adapting to associated technology.

PRs can prove to be of much benefit for host states in substantially increasing economic, social and environmental development if used effectively and efficiently without misusing them. There are both negative as well as positive experiences. If used in a right way can result in success of investments for both host as well as investor countries. For these reasons, countries over the years have started including Prohibition on Performance Requirements (“PPR”) approach in IIAs. It has also drawn the line of difference in the way that developing countries are in support of these PRs and on the other hand developed countries have criticized the use of PRs.

PROHIBITION ON PERFORMANCE REQUIREMENTS

Performance requirements are the policy instrument tools used by the host states with an intention to achieve economic and industrial base. As we have moved forward, states have started prohibiting these requirements in IIAs. PPRs are meant to eliminate the detrimental effect on trade by Performance Requirements.

PPRs were emerged in 1980s.⁹ PRs were majorly prohibited in the BITs between US and Canada and there were clauses which were aimed at eliminating practices such as local content, restriction to hire only domestic personnel and the imposition of duty to export specific amount of products because these practices were considered very much undesirable and inconsistent with the concept of liberal markets.¹⁰ Article 1106 of NAFTA also provides for the list of prohibited PRs.¹¹

TRIMS- WTO

TRIMs agreement in WTO provides for the detailed list of prohibited performance requirements.¹² It is provided in the TRIMs agreement that any TRIM which is inconsistent with Article III or Article XI of the GATT shall not be applied by any member. The measures that are incompatible with the mentioned articles can be categorized into two groups.

First group of category which is incompatible with GATT articles are in context of inconsistency with National Treatment Principle which is provided under Article III of GATT. These contain the requirements such as:¹³

1. Conditions requiring the use of local or domestic products by investor country.
2. External Measures which restricts the imports by investor country against the local products that they purchase or use.

Second group of category contains measures that are inconsistent with Article XI of the GATT.

1. Internal Measures which limits the use of imported goods after their purchase.

⁹ BARTON LEGUM, CONTEMPORARY ISSUES IN INTERNATIONAL ARBITRATION AND MEDIATION: THE FORDHAM PAPERS 55-56 (2007)

¹⁰ DOLZER, *Supra*, at 82

¹¹ *id* at 83

¹² *Id* at 83

¹³ SUZY H. NIKIEMA, PERFORMANCE REQUIREMENTS IN INVESTMENT 5 (2014)

2. The limitation imposed on the use of foreign currency which ultimately leads to the limitation on the use of imported products.
3. Measures restricting exportation of products by an enterprise.

However, only some section of Performance Requirements is prohibited in WTO. Only those PRs which are in contravention to Article III. and Article XI. of GATT are prohibited otherwise host states are at liberty to use other PRs. Even these prohibited PRs contain certain exemptions which can be used by host states. However, there are some treaties that contain prohibition of PRs beyond those mentioned in TRIMs Agreements. This poses risk on host country's government.

NAFTA

The other example of the agreement which imposes certain prohibitions on PRs is NAFTA. Article 1106 of NAFTA clearly specifies that no country which is a member to NAFTA can impose restrictions on investor enterprises such as use of domestic content, technology transfer, exporting certain fixed amount of products, achieving balance of trade by putting restrictions domestic sales or prioritizing domestic sources.

These prohibitions are imposed mainly for two reasons. First reason is, they eradicate trade distortions that come in the way by these PRs and second reason is that they allot trade autonomy to investor party by allowing them to take their own decisions relating to sales and sourcing decisions without any restrictions by the way of performance requirements.¹⁴ In some cases, these prohibitions are also in relation to incentives that host country's government provide in order to induce investor country to accept these requirements. These requirements with incentives are so much trade distortive that it becomes mandatory to prohibit them in order to ensure free flow of FDIs.¹⁵

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¹⁴ DANIEL M. PRICE, AN OVERVIEW OF THE NAFTA INVESTMENT CHAPTER: SUBSTANTIVE RULES AND INVESTOR-STATE DISPUTE SETTLEMENT 729 (1993).

¹⁵ *Id* at 729

In this regard, there are wide range of BITs including PPRs. Earlier, performance requirements were not prohibited but with the changing times, more and more number of BITs have started including clauses regarding PPRs. There is a long list of BITs prohibiting PRs such as Chile-Mexico FTA (1999), India Kuwait BIT (1991), US- Cameroon BIT (1986), 2004 US Model BIT, El- Salvador Peru (1996).

TYPES OF PROHIBITIONS

Generally, IIAs include one of the three models regarding treatment of Performance Requirements.

First model does not allow host countries to explicitly include any performance requirements. This model has remained prevalent and its prevalence indicates that developing countries would still want to include certain performance requirements in at least some cases.¹⁶ However, these requirements would not be in contradiction to some basic obligations such as National Treatment Principle or TRIMS agreement of WTO. Host countries include only those Performance Requirements which are in consistence with general treaty obligations.

Second model is generally adopted by IIAs concluded by European Union.¹⁷ Here one or both the parties are required to comply with provisions given in TRIMS agreement. If the parties are members to TRIMS agreement then there is no need to include any other obligations.

The third model is wider than earlier two models. It includes provisions relating to prohibition of performance requirements beyond those which are already given in TRIMS agreement.¹⁸ This model was used by US as they included prohibitions given under NAFTA (Article 1106). The list of performance requirements is very broad and wide therefore these agreements prohibits only certain specific performance requirements such as technology requirements, local content requirements, export requirements, or requirements relating to imports.

PERFORMANCE REQUIREMENTS IN THE PRESENT SCENERIO

¹⁶ United Nations Conference on Trade and Development, *International Investment Agreements: Trends and Emerging Issues* 41 (2006)

¹⁷ *Id*

¹⁸ *Id* at 42

Performance Requirements were used substantially by large number of countries. They were used extensively by developed countries in between 1970s and 1980s. With the time, there use by developed countries has declined because of various reasons. This does not indicate that they have completely stopped bringing the provisions related to PPRs in their IIAs. They have adopted similar strategic and trade policy instruments such as Incentive based Requirements and Rules of Origin which has somewhat similar objectives as Performance Requirements.

Developing countries are still using the practice of imposing mandatory requirements on investors with the intention of growing and promoting their industries. There was some survey of around 400 European business executives and it was found that performance requirements were majorly concluded by China, India, Brazil and Russia and various other large developing countries but according to general policy trends, developing countries are shifting their practice of mandatory performance requirements on investors to investment incentives.¹⁹

It has, however, been recognized that many host countries consider performance requirements as an important factor for their economic policy development. The recent IIAs contain strict measures on the treatment of performance requirements but have also given some discretion to the host countries regarding the use of performance requirements keeping in mind, to achieve the balance between economic policy development and investor protection. One way in which it can be addressed is by allowing parties to provide for exceptions to prohibition on performance requirements. Another method is by distinguishing between two types of performance requirements. First type which consists of unenviable performance requirements should be prohibited from being imposed on investors. Second type consisting of less unenviable performance requirements may be imposed on investors with a condition that they will receive certain benefits. This means that investor countries will get certain benefits and advantages if they agree to fulfill performance requirements imposed by host countries.

One rare feature that is used by recent IIAs, is to provide for prohibition on performance requirements for all investments and not only to those investors who are parties to the agreement.

¹⁹ United Nations Conference on Trade and Investment, *FDI Policies for Development: National and International Perspective* 119 (July, 2003)

This practice is to ensure that there is no discrimination between investments of different nationalities.²⁰

HOW PERFORMANCE REQUIREMENTS ARE ADDRESSED IN IIAs?

Bilateral and Regional Level IIAs have now started imposing certain restrictions on performance requirements. Traditionally, there were no provisions for the treatment of PRs but this has changed with time. Various options available at this level are:

- i. To impose prohibitions which are not included in TRIMs agreement.
- ii. Not to impose additional prohibitions but save the same for those covered by TRIMs agreement.
- iii. To make reference to other agreements.
- iv. To include prohibitions on certain performance requirements but also allow some exceptions.
- v. To provide for provisions on measures which are not included in TRIMs agreement.

In IIAs, at the multilateral level, TRIMs agreement of WTO compels its members to abandon the use of performance requirements which are considered to be detrimental to FDIs and trade distorting. Some of them are export requirements, local content requirements, trade balancing requirements and other requirements relating to imports. Countries may opt to adopt provisions of TRIMs as it is or may choose to renegotiate it.

Renegotiation can also be done by extending transition period or providing for new transition period. Transition period is the period for phasing out inconsistent measures for developing countries and LDCs at different stages of development. Provisions of agreement will apply to all WTO members except those granted extended transition.

Different countries have different views regarding the treatment of performance requirements. Governments of some developing countries are of the view that TRIMs agreement should be recreated and include more flexible and liberal policies allowing government to decide whether to use performance requirements or not. One such example is where India and Brazil favored

²⁰ United Nations Conference on Trade and Development, *International Investment Agreements: Trends and Emerging Issues* 43 (2006)

reopening of TRIMs agreement while in communication with WTO. They said that it should contain more flexible policies so as to allow greater freedom to developing countries or the other option proposed was to extend the situations where countries can deviate from the compliance of provisions of Article 2.²¹

On the other hand developed countries are of the view that more regulations are desirable in context of performance requirements. One such example is in the communication with WTO, US has advocated that more items should be included in the prohibited list of TRIMs agreement.²² They argued that prohibiting mandatory requirements will be in the self interest of developing countries because they result in deterring inward FDIs.

The perception of some scholars is that developing countries are already in the position to determine how some requirements can result in losing FDIs. This is evident from the example that mandatory requirements in developing countries have declined over the time because they were aware that they need to strike the balance between development and investor protection to keep the consistent flow of FDIs in their country. For this reason, they should be given freedom to take the risk of losing investments by imposing certain performance requirements because they have the realization regarding the level of requirements which is safe to impose.

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CONCLUSION

Traditionally, performance requirements were included in IIAs at a wider scale by both developing and developed countries. It was an important policy tool for development in developing countries but everything has changed with time. Developed countries started to realize that PRs are having more of a distorting effects on trade rather than positive effects. But this does not mean that they have stopped using it. They still are including some similar kinds of techniques and tools for development. They have not completely abandoned the practice of imposing requirements.

In the case of developing countries, PRs still remain important tool for development but they have realized over time that in the time of globalization where high level of competition persists in trade and everything, it is dangerous to include mandatory requirements in their IIAs. This may directly

²¹ United Nations Conference on Trade and Development, *Foreign Direct Investment and Performance Requirements: New Evidence from Selected Countries*, p. 37 (Oct., 2003)

²² *Id* at 39

result in losing FDIs. They have instead started including majorly incentive based PRs which induce countries to comply with host country's requirements.

The question that whether performance requirements will act as development tool or will have a distorting effect on trade still remains controversial and there is no full proof answer on its efficiency. Moreover, future treatment of performance requirements needs to give space to developing countries to create sufficient development policies.

