

## Reducing Foreign Investment Risk in Central America: The Investment Chapter of the CAFTA-DR<sup>\*</sup>

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The current public debate over the Central American-Dominican Republic Free Trade Agreement (CAFTA-DR) seems to have muddled understanding of the agreement's content and its likely effect on US business. The treaty's most ardent opposition, the US sugar industry, labor, and a portion of the environmental lobby, have successfully positioned the treaty as a harbinger of the American sugar industry's demise and a new impetus for a race to the bottom of labor and environmental standards. Similarly, CAFTA-DR supporters probably oversell the agreement's ability to increase US exports.

While debate over a trade agreement should come as no surprise, the hyperbolic claims of each side distract focus from one of the CAFTA-DR's most attractive attributes: its reduction of political and country risk for US investors.

Before examining the CAFTA-DR's investment provisions it is worth taking a brief look at how the agreement is likely to effect trade and its potential effects on labor and environmental standards. The current trade arrangements governing the majority of US-Central American trade, the Caribbean Basin Initiative (CBI) and the Generalized System of Preferences (GSP), already provide duty-free access into the US to about 75% of products originating from the CAFTA-DR region. While US exports into the region increased by 16% since 2000, US goods currently face tariffs that are higher than those imposed on imports from the region. Thus, because the US market is already largely open to Central American imports, the majority of the reductions in trade barriers for which CAFTA-DR provides will be borne by Central American countries. Amongst the US sectors that have most to gain from the agreement are the agriculture, service, consumer product, and technology sectors. However, the effect of the CAFTA-DR on aggregate US exports will be small and selling the agreement as a boon to US exporters could prove deleterious to future trade negotiations if expectations are raised too high.

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## **Environmental and Labor Standards in the CAFTA-DR**

Incorporating labor and environmental standards within a FTA is sticky work. Overly burdensome regulation may reduce the comparative advantage of countries with low-cost labor or lax environmental regulation by increasing labor or compliance costs and thus reducing the economic development effects of free trade. On the other hand, insufficient labor regulation coupled with freer trade can exacerbate the income disparity effect of free trade and create a public backlash against openness. Similarly, some fear that lack of provisions for environmental protection in trade pacts may lead to a race to the bottom for environmental standards, although empirical work regarding the race to the bottom effect of freer trade, for both labor and environmental standards, has yet to show that such a deterioration of standards has occurred. Nevertheless, the need to include some level of labor and environmental standards within trade pacts is generally assumed to be beneficial and inclusion of such standards has become an increasingly common facet of trade negotiations.

The framework for labor and environmental standards set out in the CAFTA-DR is known as “enforce-your-own-laws” standard, which leaves the majority of enforcement responsibility in the hands of individual member-states. This leaves labor-rights and environmental-protection advocates fearful that countries may ignore the agreement’s labor and environmental content to increase their country’s attractiveness to international investors. While the means for enforcing labor and environmental standards and the allocation of monies for technical assistance to improve worker and environmental conditions within the CAFTA-DR could be improved, failure to ratify based on these imperfections would be a mistake that would harm not only the economies of member-countries but could stall future trade negotiations and decrease the likelihood that future pacts will contain labor and environmental provisions.

## **CAFTA-DR and Investment**

The effect of the CAFTA-DR, and free trade agreements (FTAs) in general, extend beyond tariffs and quota reductions. Besides setting schedules for tariffs and quota elimination, FTAs generally include chapters that set standards for environmental and labor conditions and for the treatment of foreign investors among member-states. In the case of the CAFTA-DR, the agreement’s content regarding foreign investment, Chapter 10 of the agreement, is particularly important in the mitigation of political and country risk: factors that have heretofore deterred many foreign investors from entering the region. It is the risk mitigating effect of the CAFTA-DR’s investment chapters that will be the focus of the following article.

Political risk, namely risk associated with the political climate of a given country, is present in all cases of international investment. While this paper focuses primarily on political risk as it pertains to foreign direct investment (FDI), which occurs when a foreigner purchases physical assets of and within another country and gains a degree of operational control over the selling firm, the treaty also provides protection for foreign portfolio investment, which refers to foreign purchase of a country's assets in which no degree of control is afforded to the purchaser.

The negative effects of political risk on business are well documented. In a survey of nearly 4,000 companies, Pfeffermann and Kisunko, observe that businesses cite corruption and unpredictable judicial systems as the second and third greatest obstacles to doing business (the greatest factor being taxes).<sup>1</sup> The importance of a country's political climate has also been observed in foreign portfolio investments, as in countries with opaque governance, measured by the transparency of a country's legal system, macroeconomic policies, accounting standards, regulatory systems and the prevalence of corruption, bondholders seek premiums of up to 13%.<sup>2</sup>

The political risk-mitigating characteristics of CAFTA-DR can be classified as either direct or indirect. The direct means by which the agreement reduces political risk generally entail the circumvention of domestic policies, legal codes, or institutions through the provision of alternative settlement mechanisms or international investor treatment standards. The agreement also provides significant indirect means for reducing risk, which will be discussed briefly in this article's conclusion.

The primary political risk mitigating mechanism of CAFTA-DR are the investment chapter's provisions that guarantee investors' rights to third-party arbitration and those that establish treatment standards for foreign investors. Currently, within the CAFTA-DR region, only Honduras has a bilateral investment treaty (BIT) with the US that would provide investors with the protection that the CAFTA-DR would extend to the rest of the region.

While the functioning of the justice system and overall political climate has, on average, improved in Central America over the past ten years, the majority of the region's justice systems remain characterized by corruption and political influence. Thus the importance of the CAFTA-DR investment chapters is found in

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<sup>1</sup> Pfeffermann, G., and Kisunko, G. 1999. Perceived Obstacles to Doing Business: Worldwide Survey Results. *IFC Discussion Paper 37*.

<sup>2</sup> Wei, S.-J., and Hall, T. W. 2001. Investigating the Costs of Opacity: Deterred Foreign Direct Investment. PriceWaterhouseCoopers Report.

their ability to reduce the high political risk that is associated with corruption and cronyism in the region.

### **Investment Treatment Standards in the CAFTA-DR**

The CAFTA-DR investment provisions, laid out in Chapter 10 of the agreement, explicitly and comprehensively forbid differential treatment of foreign investments from Party states. Such protection is provided by means of national treatment provisions; which stipulate that foreign investments be treated no less favorably than domestic ones, most-favored-nation treatment (MFN); which assures that investors from Party states are treated no less favorably than those from any third-party state, and minimum standard of treatment; which guarantees that treatment is no worse than is stipulated by customary international law. Essentially the national treatment and MFN provisions ensure nondiscriminatory treatment and the minimum standard of treatment provision assigns a threshold or a floor for investor treatment.

The national treatment section also covers discriminatory actions by municipal governments. Protection against unfair actions by municipalities is particularly important in Central America where the central government's monitoring of local government is limited and municipal governments have been known to impose discriminatory post-investment changes in regulatory or tax treatment. Besides the agreement's explicit inclusion of municipalities, recent arbitration decisions support foreign investor's protection against municipal governments.

In September 2003, the International Centre for Settlement of Investment Disputes (ICSID) heard a case in which a U.S. corporate vehicle, wholly owned by a U.S. national, claimed damages for alleged expropriation said to be in violation of the terms of the Ukraine-U.S. BIT. The Ukraine government objected the claim upon grounds of jurisdiction stating that the expropriation was the act of a municipal body rather than the central government. The arbitration tribunal ruled that according to international law, actions of municipalities are attributable to the State of which they are part.<sup>3</sup>

The treaty's investment chapter provides protection against expropriation by means of consent by all signatories to abide by customary international law related to expropriation and compensation. Specifically, the treaty forbids all expropriation unless it is proven that the property is intended for public use and has been selected in a nondiscriminatory manner. If a seizure is deemed to be

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<sup>3</sup> Generation Ukraine v. Ukraine, ICSID CASE No. ARB/00/9, (2003).

for public use and nondiscriminatory, the treaty requires that appropriate and timely compensation be provided by the sizing state.

Besides reducing risk associated with unfair treatment by the host government, the investment chapter of the CAFTA-DR reduces country risk as it pertains to commercial losses due to conflict or strife. In particular, the agreement contains an Article on Treatment in Case of Strife, which requires that investors be compensated for losses incurred from armed conflict or civil strife within the host Party State. While the likelihood of strife has declined of late, the region's historically volatile socio-political climate makes the Article on Treatment in Case of Strife of particular importance to international investors.

Finally, Chapter 10 of the CAFTA-DR ensures that investors are freely able to transfer assets into and from a member-state. The Transfer Article provides that, barring extraordinary cases such as bankruptcy or pending criminal charges, parities shall be permitted to transfer all forms of assets, at the market rate prevailing during the time of transfer, without state interference.

### **Investor-State Dispute Settlement**

Means for enforcement of the treatment standards provided to investors by the CAFTA-DR is provided in Section B of the Investment Chapter, which allows ICSID arbitration as means of dispute settlement. That is, should an investor deem a state's action contrary to one or more of the agreement's provisions, the investor may bring claim against the state to an impartial arbitral body that assures final, binding and enforceable settlements. Should the State fail to adhere to the ruling of the arbitral panel, it would be found in violation of the ICSID Convention and the investor's home State could then refer the dispute to the International Court of Justice. The CAFTA-DR's arbitration provision is of particular importance as it allows investors to circumvent domestic judicial systems, which may not provide timely, competent or impartial means for dispute settlement.

## Conclusion

While the CAFTA-DR's Investment Chapter cannot completely insulate investors from the political or country risk associated with foreign investment, by providing a coherent and binding framework for investor treatment, the agreement does much to reduce these risks. Besides the direct means of reducing political risk contained in the Investment Chapter, ratification of CAFTA-DR could have an indirect risk mitigating effect by promoting democratic governance and open markets.

While civil society in Central America and the Dominican Republic is by no means unanimous in support of the agreement, the majority of the public in these countries support the treaty and the changes it entails. Failure to ratify could bolster leftist or anti-US sentiment and increase the likelihood of a return to socialist governance or even civil strife. On the other hand, US ratification of agreement would reinforce the region's positive movement towards democratic governance and market-based economies.

Finally, increased Central American integration should increase intra-regional regulatory competition, which will create incentives to improve the overall business climate of the region. As countries compete to attract investment, the countries that prove most effective at reforming inefficient bureaucracies, reducing corruption, simplifying legal codes, improving the functioning of the judicial system and increasing the rule of law will prove the most successful in attracting investment. Thus, the agreement provides an incentive to improve business climates so as not to fall behind their regional peers. The agreement also creates an incentive for the harmonization of regional institutions, policies and legal codes, to increase the competitiveness of the region as an investment host. As burdensome business climates and disaccord among legal and regulatory codes are some of region's primary barriers to economic growth, improvements in these areas could have a large effect on the reduction of poverty.