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Interaction of Tax Incentives and Performance Requirements in Bilateral Investment Treaties: Its Role in Implementing Right Institutions in Developing Countries

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ESSAY

INTERACTION OF TAX INCENTIVES AND PERFORMANCE REQUIREMENTS IN BILATERAL INVESTMENT TREATIES: ITS ROLE IN IMPLEMENTING RIGHT INSTITUTIONS IN DEVELOPING COUNTRIES

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ABSTRACT

After a failure of the Washington Consensus, many recommend that developing countries implement right institutions (i.e. institutions that are tailored to local environments and socio and political cultures) for further development. Bilateral Investment Treaties (hereinafter “BITs”) could be a good alternative instrument to establish the right institutions since the treaties significantly impact the institutions of one’s nation. The essay introduces ways to carve out a lawful combination of tax incentives and performance requirements in BITs, which could may foster right institutions in developing countries. This essay contributes to the literature by 1) reconciling the concept of right institutions in law and development with the BIT literature and 2) examining the methods to identify certain types of tax incentives and

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The Washington Consensus\(^1\) (i.e., heavily standardized policies that focus primarily on market liberalization and privatization employed throughout the late 20\(^{th}\) and early 21\(^{st}\) centuries), while arguably effective in the developed world, has failed to provide the strategies needed for further economic growth in developing countries\(^2\), even though each of its policies made sense for a particular country at a particular time.\(^3\)

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\(^{1}\) Washington Consensus is a shared set of opinions on “effective development strategies that have come to be associated with Washington-based institutions: the [International Monetary Fund (“IMF”)], the World Bank, and the US Treasury.” The Washington Consensus is based on three underlying principles: market economy, openness to the world market, and macroeconomic discipline. Generally, the Washington Consensus is “market fundamentalism,” the notion that the free market is the solution to most economic problems. See Narcis Serra et al., The Washington Consensus Reconsidered 3 (Narcis Serra & Joseph E. Stiglitz, eds., 2008).


The progressive removal of trade barriers through the General Agreement on Tariffs and Trade (“GATT”) and the World Trade Organization (“WTO”), have contributed to the raising of living standards throughout many parts of the world while exacerbating inequalities in industrialized nations. Many scholars agree that this is because developing countries failed to establish “right institutions” (i.e., a series of regulatory measures that reflect the local market conditions and culture) that are critical for the Washington Consensus policies to perform well.

The three major international organizations associated with the Washington Consensus – namely the Bretton Woods triumvirate of the WTO, the International Monetary Fund (“IMF”), and the World Bank, have recognized the problem of underdevelopment throughout the world but have been unsuccessful in establishing right institutions in developing countries. The IMF and the World Bank started “ownership programs” in order to allow developing countries to draft their policy conditionality by themselves, because those countries presumably know best their local market conditions or culture in order to establish


5. The term “right institutions” refers to institutions that are tailored to the local environment or culture of a state. Because developing nations are different from developed nations in that they face many different constraints and challenges, so institutions that tend to perform well in developed nations may not work well in developing nations. Developing nations do not require an extensive set of institutional reforms. Rather, they need to diagnose their own problems and find an “appropriate” arrangements to further their growth. By doing so, the developing nations can find their own country-specific development paths based on their institutional capacity. In other words, developing countries should adopt experimental attitudes for policy formulation and selection because the economy of each developing state is at a different stage and each state has a different institutional capacity. See generally DANI RODRIK, ONE ECONOMICS MANY RECIPES, GLOBALIZATION, INSTITUTIONS, AND ECONOMIC GROWTH 229 (2008) (arguing that the establishment of “right institution” is a critical element of further economic growth for developing nations).

6. This essay uses the concept of “institution” in an open-ended manner to include not only organizations but also regulatory frameworks with economic agendas. See generally JAN KLABBERS, AN INTRODUCTION TO INSTITUTIONAL LAW 3 (2009) (“there is no firm line dividing the institutional from the substantive”).

7. Conditionality is the attachment of conditions to the provision of benefits such as a loan, debt relief, or bilateral aid. These conditions are typically imposed by international financial institutions or regional organizations and are intended to improve economic conditions within the loan recipient country. See IMF Conditionality, INTERNATIONAL MONETARY FUND, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/21/28/IMF-Conditionality [https://perma.cc/H3VA-Y4CE] (last visited Oct. 24, 2017).
their own right institutions. The results, however, are unsatisfactory. The IMF and the World Bank are criticized about their continuous and unnecessary interventions into the conditionality drafting process. For its part, the WTO recently promulgated the Trade Facilitation Agreement aimed at removing bureaucratic barriers to the transit of goods across international frontiers in developing countries, however whether it will succeed in operation is another question, as many of the world’s poorest countries lack the infrastructure necessary to achieve its aims. Similarly, the WTO’s provisions on Special and Differential Treatment for developing countries have yet to be effectively implemented by the countries they were designed to help.

Over the past few decades, Bilateral Investment Treaties (“BIT’s”) aimed at increasing foreign investment flows, have been regarded as an instrument for Washington Consensus and neo-liberalist ideas. The

8. See Graham Bird, Reforming IMF Conditionality: From ‘Streamlining’ to ‘Major Overhaul’, 10 WORLD ECON. 81, 91 (2009) (For instance, the IMF approved new conditionality guidelines in its “streamlining” initiative in 2002 aimed at reducing the number of conditions to include only structural conditions that were deemed critical to the overall success of the program. The main purpose of the new guidelines was to encourage stronger ownership by host states of economic reform to make the IMF program more effective and to ensure that conditionality was more tailored to recipient countries’ different economics situations and cultures. Consequently, the IMF has allowed countries receiving loans to be primarily responsible for selecting, designing, and implementing policies that will make the conditionality program successful. However, contrary to the IMF’s expectations, the new guidelines on conditionality have failed. Although recipient countries draft letters of intent, in most cases the IMF determines the specificity of the conditions while recipient countries lack significant space to negotiate changes to the conditionality. Certain national authorities continue to complain about IMF inflexibility and perceive the IMF as an agent for imposing the “Washington-Consensus-like” policies). See also James M. Boughton, Who’s in Charge? Ownership and Conditionality in IMF-Supported Programs 9 (Int’l Monetary Fund, Working Paper No. WP/03/191, 2003).

9. Bird, supra note 8 at 100.


12. See generally M. Sornarajah, Mutations of Neo-Liberalism in International Investment Law, 3 TRADE L. & DEV. 203, 210-15 (2011) (Neo-liberalism refers to the revival of market fundamentalism in the post-Cold War period because of the failure of communism in the Soviet Union. The paper classifies four stages of international investment law and defining the third stage as an era related to the preference for market-based solution. The ascendancy of neo-liberalism in 1990’s led to the development of secure investment protection norms based on the notion that investment flows would be promoted through the neo-liberal philosophy that came do dominate in this period. This is probably rooted in the dissolution of the Soviet Union, which signaled the end of communism and left democracy and market fundamentalism as the prevailing philosophy at the end of the Cold War).
assumption behind this was that foreign investment was so crucial to economic development that its flow should be facilitated through strong protection for investors. The protections are in the form of guarantees against expropriation without compensation and vague concepts like Fair and Equitable Treatment, even where this posed a risk that host states would face liability in investment tribunals for monetary compensation of multinationals.  

The wisdom of this proposition is currently undergoing major criticism because many developing states that adopted Washington Consensus and neo-liberal policies through investment treaties experienced low economic development, which has resulted in an overall decline in economic growth. Others, have witnessed widening gaps between the rich and the poor. Signed BITs ultimately caused governments in developing countries to lose their economic sovereignty, which in turn, substantially reduced their policy space for implementing the right institutions geared to their economic and social needs.

Based upon this, this essay views international investment law, as captured by the regime of global BITs and variously interpreted and applied by investment tribunals, as a better instrument to implement the right institutions because of its capacity for flexibility and case-by-case customization. International investment law is depicted as a suitable alternative to the stifling conditional programs imposed by the IMF and the World Bank, and the largely ineffectual trade norms of the WTO as encompassed by the Washington Consensus packaged “solution.” The BITs, of which there are now more than 3,000, with many signed by developing nations—could instead help these countries in establishing their own “right” or “appropriate” institutions. This is because BITs, while framed as a series of international legal obligations that are themselves largely standardized, reveal the capacity for the creation of

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14. Sornarajah, supra note 12, at 203 (explaining how signing the investment treaties resulted a economic failure. Argentina, for instance, signed several investment treaties, including one with United States. The neo-liberal policies led to an economic crisis that resulted in a devaluation of the state’s currency by the government used, which adversely affected foreign investors. This measure resulted in forty-six claims for investment treaty violations, which incurred billions of dollars in adverse arbitral awards against Argentina).
15. See Vandevelde, supra note 13, at 92.
highly individualized domestic institutional structures within developing host countries.16

Following from the above, this essay will introduce the ways to carve out certain types of tax incentives contingent on a particular, often unexplored feature of BITs, namely those which deal with the control of performance requirements. Generally, BITs do not apply to tax measures.17 That is, host countries have total discretion to exercise their tax incentives policies irrespective of signing BITs. However, many developing nations fail to recognize that prohibition of performance requirement18 provisions in BITs restrict a certain form of tax incentives that are contingent on host states imposing performance requirements on investors as a condition of entry or receipt of favorable treatment under domestic laws. This becomes a critical problem when a combination of tax incentives and performance requirement is actually the right institutions that is needed as a developmental strategy for a given nation.

The essay illustrates how tax incentives and performance requirements interact with each other and introduce methods by which an economic policy environment may be established which is both legal and, crucially, conducive to development. As such it may be termed the right institutions, or institutional framework, to contrast to the ponderous and oppressive prescriptions of the IMF and World Bank. Academic legal literature has paid limited attention to the

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16. Jeswald W. Salacuse, *The Law of Investment Treaties* 129 (2d ed. 2014) (explaining that the BIT affects the institutional arrangement of host countries); Joshua Boone, *How Developing Countries Can Adapt Current Bilateral Investment Treaties to Provide Benefits to Their Domestic Economies*, 187 Global Bus. L. Rev. 187, 196-97 (2011) (This article claims that performance requirements are likely the most powerful regulatory methods for developing countries. A developing nation should require technology transfers or limitations on technology licensing fees. This helps establish new markets and increase efficiency and production within the new domestic market of a developing state because it would allow the country to use, acquire, produce, and adapt foreign technology).


18. David Collins, *Performance Requirements and Investment Incentives Under International Economic Law* 9-10 (2015) (explains that there is no universally adopted definition of performance requirements. Some describe them as all “host state country operational measures.” In general, the term “performance requirements” refers to a variety of regulatory measures imposed by host state governments on the activities of foreign investors. Performance requirements take the form of various conditions imposed upon foreign investors. For example, a host country could require a foreign investor to form a joint venture with a local business or require the foreign investor to possess a certain quantity of foreign capital to fund their operations).
performance requirement provisions in BITs and their impact on tax incentives. In contrast, this essay will demonstrate how performance requirements interact with tax incentives and the ensuing its implications as a tool of development. More specifically, this essay will illustrate how developing states could carve out tax incentives contingent on performance requirements based on the wording found in the US Model BIT 2012.

II. TAX INCENTIVES AND PERFORMANCE REQUIREMENTS IN BILATERAL INVESTMENT TREATIES

This section will first briefly introduce the concepts of tax incentives and performance requirements and then explain how they are dealt with under international law.

A. Tax Incentives

Investment incentives can be defined as any measurable advantages accorded to specific firms by a host government to encourage them to engage in operations of a certain variety; typically, this means foreign direct investment (“FDI”) in a certain sector. Investment incentives are akin to subsidies in that they grant advantages to certain firms which allow these firms to operate in a favorable position in their respective markets. Unlike performance requirements, incentives are not generally controlled by international law. The only international legal instrument which affects the use of incentives is in the context of trade law where subsidies assisting goods aimed at export markets are prohibited. Some investment treaties also have a minor limiting impact on the use of investment incentives. For example, North American Free Trade Agreement (“NAFTA”) denies parties the ability to attract foreign investors by lowering regulatory standards of certain areas, notably the environment.

Simply put, a tax incentive is an aspect of a country’s tax code designed to incentivize, or encourage a particular economic activity. They are special exclusions, exemptions, or deductions that provide

19. See id. at 2.
20. See generally WORLD TRADE ORGANIZATION, AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES (1995) [hereinafter ACSM].
special credits, preferential tax rates or deferral of tax liability.\textsuperscript{22} Tax incentives take a variety of forms such as reduced corporate income tax rates, tax holidays, investment credits, sales tax or VAT reductions, and property tax reductions. Incentives are sometimes broadly or narrowly targeted. Tax incentives could specifically target export-oriented investment or the research and development sector depending upon ones’ policy preferences.

Tax incentives have many advantages.\textsuperscript{23} First, tax incentives encourage technology spill overs and hire more local employees, which increase the level of FDI.\textsuperscript{24} However, tax incentives may also have a downside. For instance, it can lead to a market distortion by presenting an artificial advantage to certain forms of economic activity and not others, leading to a misallocation of resources in production and consumption. If tax incentives are successful, they will spur additional investment in a sector that would not otherwise have occurred. This investment will reallocate resources, which may result in too much investment in certain sectors or too little investment in another sector. Corruption on the part of those who seek tax incentives and the high cost of enforcement and compliance are other problems associated with the use of tax incentives. This is one reason why scholars have identified tax incentives, at least as tools of attracting FDI, as something of a “winner’s curse”—the country that out-competes all other countries in offering the most attractive tax incentives may end up losing out in the long term.\textsuperscript{25}

\textbf{B. \textit{Performance Requirements}}

There is no universally adopted definition of “performance requirements.” Some describe performance requirements as all “host state control techniques on operational level.”\textsuperscript{26} As noted above,

\begin{itemize}
\item \textsuperscript{22} ALEX EASSON \& ERIC M. ZOLT, WORLD BANK INSTITUTE, \textit{TAX INCENTIVES} 3 (2013).
\item \textsuperscript{23} \textit{Id.} at 10.
\item \textsuperscript{24} \textit{See generally} Andrea Fosfuri et al., Foreign direct investment and spillovers through workers’ mobility, 53 J. OF INT’L ECON. 205 (2001).
\item \textsuperscript{26} Collins, \textit{supra} note 18, at 9 (quoting C. WALLACE, THE MULTINATIONAL ENTERPRISE AND LEGAL CONTROL: HOST STATE SOVEREIGNTY IN AN ERA OF ECONOMIC GLOBALIZATION 326 (2d ed. 2002)).
\end{itemize}
usually performance requirements are described as conditions imposed on foreign investors that require they achieve certain goals with respect to their commercial activities in host countries. Performance requirements are used with other policy tools, such as traditional investment incentives, to attain certain economic development objectives. Performance requirements may compel a foreign firm to adopt a certain structure, such as a joint venture with a local partner, or possess a certain quantity of foreign capital to fund their operations. Performance requirements may appear to be the counterpart to investment incentives in that they impose obligations on investors, while investment incentives grant them rights.

Performance requirements are prohibited by most BITs and by the WTO’s Agreement on Trade-Related Investment Measures (“TRIMs”). This is based on the notion that such requirements control the behavior of foreign investors in a manner which is distortive of international markets and, therefore, counterproductive. In the case of TRIMs, a subset of performance requirements known as “trade-related investment measures” are prohibited because they compel foreign firms to use domestic goods, even where these may be more expensive or of lower quality. This provision of TRIMs reiterates that the national treatment requirement found in Article 3 of the GATT, which essentially prohibits discrimination against foreign goods, the foundation of the WTO’s emphasis on liberalized trade. Developing countries prefer to utilize TRIMS measure, due to its important nature in the economic policy of pre-industrialized or newly industrializing countries.

Most of the prohibitions on performance requirements in BITs consist of a simple restatement of the obligations imposed under TRIMs, which means TRIM signatory states which are also WTO Members would already be required to not impose such measures on foreign firms regardless of the BIT. However, some modern BITs go beyond this standard provision by specifying a broader range of performance requirements that are illegal under TRIMs. For example, in addition to the TRIMs prohibitions, NAFTA also prohibits signatory states from imposing technology-transfer obligations on foreign firms. The purpose of this prohibition appears to be the recognition

27. WTO, AGREEMENT ON TRADE-RELATED INVESTMENT MEASURES art. 2 (1994) [hereinafter TRIMs].
28. COLLINS, supra note 18, at 117.
29. NAFTA, supra note 22, art. 1106(f), 32 I.L.M. at 605.
that such a requirement would place an undue burden on a foreign firm, placing it at a competitive disadvantage in the domestic market compared to local firms which do not suffer from this obligation.

C. MODEL BILATERAL INVESTMENT TREATY 2012

Having introduced the key concepts of tax incentives and performance requirements, this section examines how different types of tax incentives could be carved out through performance requirement provisions in BITs, using the US Model BIT 2012 as a representative example of such a treaty. This essay argues that such a carve out would provide opportunities for developing nations to design and protect their locally tailored tax incentives. These are the “right institutions”, meaning packages of regulations aimed at achieving economic development.

It should be mentioned that studies on reconciling taxes with BITs are in their early stages. Researchers argue BITs should regulate tax measures since the tax treaty failed to work as promised. Others reject this, arguing that tax measures should be governed only by tax treaties

30. In February 2009, the Obama Administration initiated a review of the US Model BIT to ensure it was consistent with the public interest and the Administration’s overall economic agenda. The Administration sought and received extensive input from Congress, companies, business associations, labor groups, environmental and other non-governmental organizations, and academics. The US Model BIT 2012 maintains language from the 2004 model BIT, in particular its carefully calibrated balance between providing strong investor protections and preserving the ability of the host government to regulate for the public interest. Despite these similarities, the Administration made several targeted and important changes from the previous model text to improve protections for American firms, promote transparency, and strengthen the protection of labor rights and the environment. See US DEP’T OF ST., UNITED STATES CONCLUDES REVIEW OF MODEL BILATERAL INVESTMENT TREATY, Media Note (Apr. 20, 2012), https://2009-2017.state.gov/r/pa/prs/ps/2012/04/188198.htm [https://perma.cc/W3V7-6PKV] (last visited Oct. 24, 2017).

31. See generally Thomas W. Wälde & Abba Kolo, Coverage of Taxation under Modern Investment Treaties, in THE OXFORD HANDBOOK OF INTERNATIONAL INVESTMENT LAW (Peter Muchlinski et al. eds., 2008).

32. Reuven S. Avi-Yonah & Oz Halabi, Double or Nothing: A Tax Treaty for the 21st Century, 3 (Mich. Law & Econ., Working Paper No. 66, 2012), http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1176&context=law_econ_current [https://perma.cc/H327-ARK7] (last visited Oct. 24, 2017) (arguing that tax treaties are in fact superfluous for corporate tax payers and that it would be better to protect them from exorbitant source-country-specific taxation by including tax provisions in BITs since such BITs have much stronger dispute resolution mechanisms and have most favored nation (“MFN”) provisions, so they effectively form a multilateral network).
because BITs and tax treaties have different functions and purposes.  

Recently, scholars have examined how each provision in a BIT is relevant to the assessment and enforcement of municipal tax impositions by considering “ways in which common practices can be perverted to impair investments, rather than to advance the appropriate revenue goal of the state.”

The general rule is that tax incentives may be exempt from the obligations contained in a BIT. Some BITs use a general exception to carve out all kinds tax measures. For example, Article 16 of the Canada-Mongolia BIT specifies:

7. Articles 6 (Minimum Standard of Treatment), 7 (Compensation for Losses), 8 (Senior Management, Boards of Directors and Entry of Personnel), 9 (Performance Requirements) and 11 (Transfers) shall not apply to taxation measures.

Other BITs contain a separate taxation clause stating the BIT does not apply to tax measures and that the tax treaty overrides the BIT if there is any conflict between the two.

However, the general rule never justifies developing nations freely exercising their tax incentives in any circumstance, meaning in a manner that might transgress the prohibition on performance requirements alluded to above. Many BITs, including the US Model BIT 2012, have certain restrictions on the allowance of the tax incentive measures. Unfortunately, many developing nations do not appreciate the nature of these restrictions and sign the BITs regardless, restricting their capacity to engage certain policies aimed at enhancing their development potential. This is probably because of their unequal

33. De Melo Vieira, supra note 17, at 80 (arguing that there are important differences between tax and investment treaties regarding their goals, persons/entities subject to the treaty, and protection obligations imposed on the investors. Most countries prefer to address international taxation issues in separate treaties to maintain maximum fiscal sovereignty. Although investment and tax matters are closely related, tax policies should not be driven exclusively by foreign investment concern).

34. Paul B. Stephan, Comparative Taxation Procedure and Tax Incentive in International Investment Law and Comparative Public Law 600 (Stephan W. Schill ed., 2010).


bargaining power and lack of negotiation skills. It is now well known that developing countries have limited ability to modify the terms of the model BITs presented to them by more economically powerful nations, such as the United States. This is why most ratified BITs, at least those between the United States and foreign investors, are broadly similar to those between developing nations and foreign investors in terms of their contents.

The following is an excerpt from the US Model BIT 2012 that many developing nations have accepted as the baseline for their BITs with the United States. The essay will now examine how the US Model BIT 2012 restricts certain forms of tax incentives measures:

Article 21: Taxation

1. Except as provided in this Article, nothing in Section A shall impose obligations with respect to taxation measures . . .

3. Subject to paragraph 4, Article 8 [Performance Requirements] (2) through (4) shall apply to all taxation measures.

4. Nothing in this Treaty shall affect the rights and obligations of either Party under any tax convention. In the event of any

37. Zeng Huaqun, Balance, Sustainable Development, and Integration: Innovative Path for BIT Practice, 17 J. INT’L ECON. L. 299, 302-04 (2014) (“the model gives developed state a negotiating advantage, since the party who controls the draft usually controls the negotiation.”). Most developing nations are suffering from unequal bargaining power in the BIT negotiations because they have not drafted their own model BITs. Therefore, their position is merely accepting or slightly modifying a model BIT prepared by the developed country negotiating partner. Only a few developing states have prepared their model BITs and these are heavily influenced by the model BIT of developed countries). See also M. SORNARAJAH, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT 207-08 (2004) (arguing that it is hard to expect developing nations to have legal departments sophisticated enough understand and analyze the nuances in the variations in the terms used in BITs).

38. See Huaqun, supra note 37 at 302-304.


These annexes that contain the “Schedule of Colombia” are unremarkable, until one realizes that the agreement in question is actually between Canada and Peru. Canada was indeed negotiating a PTA with Colombia around that same time, and would sign that agreement a week later. This odd insertion of language about Colombia in an agreement with Peru certainly appears to be the result of sloppy copy-and-pasting between treaties. Id. at 1.
inconsistency between this Treaty and any such convention, that
collection shall prevail to the extent of the inconsistency. In the
case of a tax convention between the Parties, the competent
authorities under that convention shall have sole responsibility for
determining whether any inconsistency exists between this Treaty
and that convention.40

The first paragraph of Article 21 carves out tax measures from the
main text of the agreement. In other words, the Model BIT 2012
generally does not apply to tax measures. The second paragraph lists
exceptions to the first paragraph, stating that some of the performance
requirements listed in Article 8 apply to all tax measures. The following
is Article 8 in the US Model BIT 2012. Its language is inspired by that
of TRIM, discussed in Part II.B above:

Article 8. Performance Requirement

1. Neither Party may, in connection with the establishment,
acquisition, expansion, management, conduct, operation, or sale or
other disposition of an investment of an investor of a Party or of a
non-Party in its territory, impose or enforce any requirement or
enforce any commitment or undertaking:

(a) to export a given level or percentage of goods or services;
(b) to achieve a given level or percentage of domestic content;
(c) to purchase, use, or accord a preference to goods produced in
its territory, or to purchase goods from persons in its territory;
(d) to relate in any way the volume or value of imports to the
volume or value of exports or to the amount of foreign exchange
inflows associated with such investment;
(e) to restrict sales of goods or services in its territory that such
investment produces or supplies by relating such sales in any way
to the volume or value of its exports or foreign exchange earnings;
(f) to transfer a particular technology, a production process, or
other proprietary knowledge to a person in its territory;
(g) to supply exclusively from the territory of the Party the goods
that such investment produces or the services that it supplies to a
specific regional market or to the world market; or

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9, 2017).
(h) (i) to purchase, use, or accord a preference to, in its territory, technology of the Party or of persons of the Party; or

(ii) that prevents the purchase or use of, or the according of a preference to, in its territory, particular technology, so as to afford protection on the basis of nationality to its own investors or investments or to technology of the Party or of persons of the Party.

2. Neither Party may condition the receipt or continued receipt of an advantage, in connection with the establishment, acquisition, expansion, management, conduct, operation, or sale or other disposition of an investment in its territory of an investor of a Party or of a non-Party, on compliance with any requirement:

(a) to achieve a given level or percentage of domestic content;

(b) to purchase, use, or accord a preference to goods produced in its territory, or to purchase goods from persons in its territory;

(c) to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment; or

(d) to restrict sales of goods or services in its territory that such investment produces or supplies by relating such sales in any way to the volume or value of its exports or foreign exchange earnings.

3. (a) Nothing in paragraph 2 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with a requirement to locate production, supply a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory.41

Paragraph 1 clearly restricts host countries from imposing any performance requirements listed in sections (a) through (h). For instance, section (a) says that the host countries should never ask foreign investors to use a domestic supplier for a certain amount of their supplies. As noted earlier, this prohibition is based upon the link between foreign investment and trade: the capacity to enter a host state should not be used as a means of distorting trade in goods.

Paragraph 2 imposes even stronger restrictions on host countries. It prohibits a host country from imposing the performance requirements listed in sections (a) through (d) of Paragraph 2, even if the host country provides the investor with an “advantage” in exchange for agreeing to the obligations. Here, the text does not define what “advantage” means, but an investment arbitration tribunal constituted under NAFTA has stated that an advantage may include tax incentives, including tax holidays and the reduction of corporate income taxes. This prevents host countries from requesting foreign investors use domestic suppliers for a certain amount of the production as indicated in section (a) or any of the other performance requirements listed in sections (b) through (d), even if the host countries provide tax incentives such as tax holiday in return. Therefore, it is clear that the US Model BIT 2012 strongly prohibits any of the performance requirements with respect to sections (a) through (d) of Paragraph 2, irrespective of the receipt of advantage by foreign investors.

Interestingly, the performance requirements listed in sections (a) through (d) of Paragraph 2 are identical to those listed in sections (b) through (e) of Paragraph 1. Then, what about the other sections of Paragraph 1? Paragraph 2 is silent on whether host countries can impose the performance requirements listed in sections (a), (f), (g), and (h) on foreign investors in exchange for tax incentives. Consequently, it can be argued that the US Model BIT 2012 permits host countries to impose the performance requirements listed in sections (a), (f), (g), and (h) of Paragraph 1 as long as they provide tax incentives to foreign investors in return, meaning that the right to enact performance requirements is conditioned on their connection to tax incentives. The presumption here may be that any harm befalling the foreign firm through the performance requirements is more than negated through the granting of the incentive advantage. Similar provisions do not exist

42. See Suzy H. Nikiema, Int’l Inst. for Sustainable Dev., Performance Requirements in Investment Treaties 2 (2014) (explaining that tax incentives can constitute an “advantage” under the performance requirements); see also Pope & Talbot Inc. v. Government of Canada, Interim Award, ¶ 73 (Arb. Trib. 2000), https://www.italaw.com/sites/default/files/case-documents/ita0674.pdf [https://perma.cc/5E9W-DNYQ] (last visited Nov. 1, 2017) (“It is common ground between the disputing parties herein, and the Tribunal agrees, that the granting and maintaining of EB [Established Base] and/or LFB [Lower Fee Base] quotas to exporters under the provisions of the ECR [Export Control Regime] is an ‘advantage’ within the meaning of Article 1106(3).”).
in TRIM, which is relatively narrow in its focus on local content rules for goods.

Paragraph 3 creates a straightforward exception to Paragraph 2, and thus provides another opportunity for host countries to experiment in establishing tax incentives and performance requirements through their BITs. For example, host countries can, in exchange for tax incentives for foreign investors, impose performance requirements that are related to training local employees or carrying out research and development works. What is given with one hand is taken by the other. The reason that this kind of incentive coupled with a performance requirement was not prohibited by the US Model BIT—or TRIM for that matter—is self-evident. Such policies are not likely to cause harmful distortions in world markets, and to the extent that they do, the distortions are mutually self-extinguishing. Most importantly, they should foster domestic economic development with minimal impact on global economic relations. This logic is captured to some degree in the language of the WTO’s Agreement on Subsidies and Countervailing Measures (“ASCM”), which is the only international agreement that effectively controls tax incentives taking the form of benefits granted to trading firms. The ASCM prohibits host countries from granting incentives for firms that produce goods aimed at the export market and where global inefficiencies may result. If there is no clear contingency on export, then actual harm must be demonstrated by the complaining state. Likewise, Article 8(3) of the US Model BIT, which outlines the types of performance requirements permitted when linked to tax incentives, does not contemplate what might be considered distortive activities. Foreign investors may be compelled to hire local workers and to train them because, unlike goods, there is no free movement of workers around the world, and therefore no taint on world markets. Research and development financing, while potentially distortive, is typically viewed as beneficial in the long run because the upfront costs of such activities would make them inefficient if they did not receive artificial state support in the early stages. In other words, not all tax


44. ASCM, supra note 20, art. 3 (injury to the domestic industry should be proven).
incentives and performance requirements are prohibited by BITs, only those which threaten economic efficiency are disallowed. In sum, host countries have full discretion to impose the performance requirements listed in sections (a), (f), (g), and (h) of Paragraph 1 and all performance requirements listed in Paragraph 3 in exchange for tax incentives for foreign investors.

The use of tax incentives to attract FDI in the Republic of Korea (“South Korea”) is illustrative of how these policies can be implemented in tandem with performance requirements in an economically productive manner. Indeed, the tax incentive offered by the South Korean government in the 1970’s and 1980’s is a well-known example of a “right” institutions.45 President Park Chung-Hee made exports his top priority and greatly expanded the scope of export subsidization. The exporters were provided with many tax incentives, such as tax exempted and duty-free imports of raw materials. The government implemented specific export targets for firms. A noteworthy feature of the South Korean tax incentive system is that the tax incentives applied not only to the final exporters, but to the indirect exporters (firms that supplied the intermediate inputs used to produce the final exports) as well.46 Most importantly, many tax incentives were given to foreign investors in exchange for transfer of technology and expertise. The foreign investors had to train local South Korean employees to receive the benefit of the tax incentives. While the export-oriented system would arguably violate TRIM today, the employment-related tax incentive would not, and would almost certainly be permitted under modern BITs modeled according to the US Model BIT.

It is worth noting that strong political stability through autocracy is one of the major foundations for the success of all tax incentive measures.47 Many government officers maintained almost daily contact with major exporters and it is common for the minister of trade to intervene in difficult situations. For example, to immediate customs clearance for inputs being delayed. All tax incentives were monitored and reviewed at a monthly trade promotion conference, chaired by the


46. Id. at 14.

president and attended by ministers, bankers and exporters. In short, a country-specific tax incentive regime established by a strong government is a good example of a right institution in tax incentive policies.

Of course, other nations may have different types of right institutions with different combinations of tax incentives and performance requirements. This essay argues that developing countries should first determine what types of tax incentives fit their local economy and identify the appropriate performance requirements that may be lawfully attached to the incentive measures. Simply put, developing nations must examine and figure out what the right institutions could be with respect to the combination of tax incentives and performance requirements. A carefully tailored approach is essential. Contrary to the regimes devised by the World Bank, the conditionality policies of the IMF, and the dubious record of special and differential treatment of the WTO, one size does not fit all. Once a state ascertains the correct form for its tax incentive regime, it must find way to arrange the measure to comply with the prohibitions on performance requirements imposed by the BIT, as captured by paragraphs 1, 2, and 3 of the US Model BIT. Depending on how the state arranges the elements, it should be able to identify the requisite policy space to carve out a country-specific form of the tax incentives and performance requirements; the right institutions for a given country and its unique circumstances. With an effective regime of tax incentives in place, developing states may eventually find themselves in a position where they can begin to gradually remove the tax incentives because they have become naturally attractive to foreign firms, thereby potentially extracting greater value in the long term.

48. Rodrik, supra note 45, at 15-16.

49. Most policy space arguments are about making provisions flexible by inserting exception clauses or preamble language. Some arguments borrow methods from WTO’s previous treatment for developing nations such as general exceptions or special and differential treatment. See e.g., Suzanne A. Spears, The Quest for Policy Space in a New Generation of International Investment Agreements, 13 J. INT’L ECON. L, 1037, 1071 (2010) (arguing that general exception clauses, such as those found in IIAs, and preamble language expressing some non-investment policy objectives, such as labor or environment protection, could provide more flexibility).

III. CONCLUSION

Readers of this essay may be surprised to learn that experienced negotiators from developed nations usually hold question-and-answer (“Q & A”) sessions during the main investment negotiation phase to facilitate the negotiation. This apparently shows the dramatic inequality of bargaining power between the negotiating parties. Negotiators from developed countries believe the Q & A session is the only way to facilitate the negotiation; it is impossible to agree on any terms during the negotiation due to the inexperience of the negotiators for the developing nation.

Likewise, many BIT negotiators from developing nations do not understand the mechanics of provisions prohibiting performance requirements in exchange for tax incentives, nor do they appreciate the nature of the obligations assumed under these treaties. Consequently, they sign the BITs that restrict the use of tax incentives and performance requirements that could actually represent the “right institutions” in a certain stage of the development. This results in a significant loss of access to policy instruments that help developing countries continue their economic growth. Developing nations must fully understand the interaction between tax incentives and performance requirements and carve out these types of measures, if necessary, during their BIT negotiations. Such strategies should preclude the need for more monolithic reform packages imposed by other Bretton Woods institutions, which, while well-intentioned, will most likely be less useful in the long run.

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