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## Foreign Investment and the Rule of Law

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En matière de régime des investissements étrangers, la plupart des PTM (pays tiers méditerranéens) ont adopté, depuis la fin des années 80, des codes d'investissements simplifiés offrant d'importants avantages fiscaux. Ces codes sont la plupart du temps reliés aux programmes de privatization. Mais la conversion radicale à l'accueil des investissements étrangers succède à plusieurs décennies de méfiance ... et les avantages maintenant proposés sont comparables à ceux de nombreux pays en développement. Il n'y a pas sur ce terrain d'avantage particulier.<sup>1</sup>

This statement, from a respected French commentator on the Mediterranean and on economic affairs, accurately sums up the current attitude towards the legal status of investment in the South Mediterranean region. However, the problems facing the private investor are far more complicated than he indicates. It is usually assumed that direct private foreign investment and portfolio equity investment, both of which fall under the rubric of 'foreign investment',<sup>2</sup> respond simply to the financial climate that exists in receiving countries. In fact, the situation that persuades an investor to invest is far more complex and the weighting given to different investment destinations and to different factors affecting investment varies from situation to situation. One highly important consideration is the legal status of institutions and of the political and economic environment in the investment destination under consideration. In this respect, the Middle East and North Africa has a series of acute problems to address if foreign investment is to reach the proportions sought within the Barcelona context. As mentioned above, two of the most important considerations relate to investor distrust and comparative advantage. Despite new and simplified investment codes designed to encourage the foreign investment decades of foreign distrust over political interference in the economic process and ideologies of state supervision have still to be effectively countered. In addition, these new investment codes have usually been produced to encourage the privatization of state assets but will

do little to encourage investment outside this arena because the region as a whole lacks comparative advantage for the foreign investor, when compared with Latin America, South Asia or South East Asia.

The role of comparative advantage is, of course, important; China, for example, which has little formal guarantee of security of investment yet, none the less offers such financial comparative advantage that foreign investors are willing to accept a far higher level of risk than might otherwise be the case, as the massive inflows of direct foreign investment in recent years demonstrates. However, the ability of a host government to create a climate of investor confidence can, on occasion, be equally as important as the consequences of the October 1994 Mexico crash demonstrated. Mexico's rapid recovery was not only due to the safety-belt provided by the United States but was also a function of the speed with which the Mexican government responded, in creating an appropriate financial and economic environment to reassure investors and in providing appropriate legal infrastructures. The reverse can be equally true, as the crisis of confidence in the wake of the moral hazard manifested in the Asian financial collapse in 1997 demonstrated. On occasion, this can work in a regional context: the initiation of the Middle East peace process in 1993 caused a rush of foreign investment into Israel – as had occurred after the 1967 victory as well, albeit for different reasons – as investors assumed that Israel itself would become the gateway into a revived Middle East economic environment. Similarly, the difficulties encountered in pushing the process forward in 1995-96 resulted in a sudden dive in investment inflows there. Trust or, rather, confidence is, in short, probably the most important consideration as far as the Middle East and North Africa region is concerned, particularly if it wishes to significantly reverse its poor record in persuading foreign investors to accept the implicit risk of investment there. In part of course, this depends on the type of investment involved.

British Petroleum has not been deterred from making a massive \$3.5 billion investment in the Algerian gas industry, despite the civil conflict there. Such investments, however, do little to alter the fundamental economic balances of the region; they allow governments to become rent-seekers rather than to encourage them to engage in creating conditions for productive investment. The reality is that, for the non-oil investor, the region has been distinctly unattractive for many years, largely because security of investment was perceived to be low – either because of arbitrary state action, particularly in nationalizing foreign assets, or because of difficulties of repatriation of profits and the constant threat of 'indigenization'.

Regional governments – except Israel and, perhaps, Turkey, where appropriate conditions for foreign investors obtain – need to devote far more attention to creating investor confidence in terms other than the simple

commercial environment. Investment codes, in short, are very important and a necessary but not sufficient condition to persuade the private investor to take risk. There is a crucial need to establish the independence of legal systems from government interference and the transparency and accountability of commercial administrations. Of course, it may be argued that this is an inevitable concomitant of economic liberalization and restructuring and of the development of international 'openness', to use the World Bank's term. This is not, however, self-evidently the case. Chile, after 1973, and Singapore suggest that other means also exist to create the climate of stability sought by the foreign investor. It therefore follows that, unless they wish to attempt the authoritarian approaches used there – which, in any case, have been responsible for significant economic and political inefficiencies in the past in terms of rent-seeking and political instability – governments in the Middle East and North Africa must actively promote steps to create political transparency, accountability and legitimacy for the very process of government itself, as much as they must ensure the independence of legal systems to which they themselves will also be accountable. In short, the political transformations required in the Middle East and North African region are as important as the specific economic measures now being undertaken by the majority, if not all of the countries concerned.

#### **The Investor's Objectives**

It is commonly thought that the primary consideration in potential investors' minds is simply the rate-of-return on investment to be expected from a particular investment destination. This is, of course, a consequence of investment opportunity itself – whether in the indigenous market or as an export generator – and of the economic environment of the country in which the investment is to be located. The latter consideration involves such factors as labour costs, input costs and availability, transport costs and the political climate for investment. The political climate is construed usually as issues such as the ability to repatriate profits and potential tax holidays, as well as other financial inducements to investors. There should, in short, be sufficient 'comparative advantage' making the investment attractive in financial terms.

There are, however, other acute considerations that affect investor decisions in choosing a destination for investment and determining the type and size of the investment to be made, particularly if 'comparative advantage' is not the decisive consideration, as is the case in the Middle East and North Africa. One such consideration, for example – as suggested above – is that the rate-of-return, however high or low it may be in comparison with investments elsewhere, should be stable and predictable. This is particularly important in investments where the real benefit to the investor occurs only

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FOREIGN INVESTMENT: DEVELOPING COUNTRIES BY REGION  
(\$ BILLION)

	FDI	1993 (%)	PEI	(%)	1994 FDI	(%)
East Asia/Pacific	37.9	55.6	18.1	38.3	43.0	53.7
Latin America/Caribbean	15.7	23.0	25.1	53.1	20.8	26.0
Europe/Central Asia	**12.0	18.2	1.3	2.8	8.4	10.5
Sub-Saharan Africa	1.8	2.6	0.4	0.8	3.0	3.8
Middle East/North Africa	3.8	5.6	*0.4	0.8	3.7	4.6
South Asia	0.8	1.2	2.0	4.2	1.2	1.5
Total	68.2		47.3		80.1	

Source: COMET, 43 (May 1995), 21

IBRD, *Financial flows and the developing countries*, August 1996;

Table A.11

Note: \*World Bank projection

\*\*Includes Eastern Europe (\$4.1 billion)

after the initial investment has been recovered, so that subsequent cash-flow streams are essentially profit. Major investments in hydrocarbons and other mining activities are a very good example of this. It should be borne in mind that high rates-of-return are often illusory, as – over time – returns tend to drift back to a basic norm related to government discount rates, according to the capital assets pricing model.

Outside the question of mining operations, decisions about investment in non-rent-related operations or in equity also often depend on considerations of long-term stability, since the real benefit to the investor will also be delayed until the initial investment is repaid. Immediate returns, therefore, are not necessarily the major consideration in making investment decisions. However, if long-term stability is a major concern, this also raises questions about both the legal status of foreign investment in a host country and about the political stability of the regime controlling it. Associated with these concerns are considerations of nationalization and compensation, as well as of the actual status of the rule of law. Indeed, the status of the legal system is a vital consideration, particularly its independence from government, as well as its ability to modify and moderate government action. In some respects, this consideration subsumes all others related to the political environment in which an investment is to be made for it will ultimately determine what that environment will be. In other words, political conditions in the Middle East and North Africa region are acutely important to the foreign investor today – outside, perhaps, the question of oil-related investment – and those conditions, in turn, are determined by the legal environment in which governments there operate, particularly the independence of the judiciary.

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### The Legal Status of Investment

If such independence is ensured, then one important aspect of this issue is the nature of the legal terms offered to foreign investors and guaranteed by the legal system.

#### Investment Codes

Until the 1980s, investment codes in developing countries, particularly in the Middle East and North Africa, were often seen to be restrictive and genuine liberalization of foreign investment codes only began towards the end of the decade.<sup>5</sup> Although there have been dramatic changes since then, the codes are often still seen by potential investors as restricted – Algeria's anxiety of economic sovereignty over the gas and oil sector is one good example. This is, of course, changing as the principles of modern economic liberalization are increasingly accepted by the governments concerned, but the South Mediterranean region continues to be one of the poorest in terms of foreign investment worldwide.

The actual levels of foreign investment inflows by country make clear the difficulties they face. Indeed, apart from Israel, Turkey, Morocco and Tunisia, foreign investment has been declining in the region – the Saudi figures are an aberration caused by the war against Iraq. Even in these three countries, the total amount of investment has been only around half of what had been anticipated or required despite modifications of law and regulation to encourage foreign investors. The picture when net foreign investment is considered is equally as depressing. The Middle East and North African region is grouped alongside South Asia and Africa in terms of its access to foreign investment world wide and, in many cases, early success in attracting foreign investment at the start of the decade has now begun to tail off. Furthermore, foreign investment is still predominantly in the form of direct investment and the very recent pick-up in portfolio equity investment in Egypt, Morocco and Tunisia reflects the one-time attraction of privatization programmes, rather than an ongoing commitment to economic arenas in which flexibility of investment offers its own rewards.

In fact, in a sample of 20 countries drawn from the Mediterranean, Latin America, the Far East and the three newest Mediterranean European Union members (Spain, Portugal and Greece), together with Eastern Europe and the former Soviet Union, the six major South Mediterranean states (Turkey, Israel, Egypt, Tunisia, Algeria and Morocco) only received seven per cent of accumulated direct private foreign investment receipts between 1971 and 1992. In comparison, 39 per cent went to South East Asia, 25 per cent to Latin America and seven per cent to the newest European Union members. Even worse, whereas the South Mediterranean states had received 11 per cent of

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FOREIGN DIRECT INVESTMENT INFLOWS  
(\$ MILLION)

	1989	1990	1991	1992	1993	1994
Algeria	12	6	10	12	15	18
Bahrain	181	-4	-7	-9		
Egypt	1250	734	253	459	493	530
Iran	-19	-362	23	-170	-50	-10
Iraq	3		-3			
Israel	125	101	351	539	555	406
Jordan	-1	38	-12	41	-34	-10
Lebanon	2	6	2	4	6	7
Libya	1225	159	24			
Kuwait	4	-1				
Mauritania	4		2	5	1	2
Morocco	167	165	320	424	522	550
Oman	112	144	149	87	99	130
Qatar	-1	16	43			
Saudi Arabia	-20	572	659	1873	-79	
Sudan	4			0	0	
Syria	74	71	62	67	70	72
Tunisia	79	75	150	379	239	275
Turkey	663	684	810	844	636	850
UAE	39	-116	-69			
Yemen	5			0		

Sources: *Comet*, 41 (July 1994): 11.  
IBRD, *World Development Report 1994*: 204-5  
IBRD, *World Data 1995*, CD-ROM

these investment flows in the 1970s, between 1990 and 1992, they only received 4.1 per cent – much of which was, in any case directed towards the hydrocarbon sector. Migrant labour transfers during the same period were five times greater than direct private foreign investment, at \$125 billion, compared with \$24 billion – a pattern which was completely reversed in the case of South East Asia.<sup>9</sup>

In fact, it is difficult to see what these countries can do in addition to the measures they have already taken to persuade foreign investors to take up the opportunities they offer, unless they can create political and cultural conditions which encourage foreign investors far more quickly than they appear to be doing at present. The region is, in short, in crisis despite the valiant efforts made – in some cases for more than a decade – to achieve economic reform and restructuring which will promote economic development. Indeed, without adequate investment, it is most unlikely that these states can resolve their internal social problems, let alone begin to match the patterns of development experienced by the countries of the developed world or of the rapidly developing world of the Far East. Unless far more foreign investment – or official development aid, presumably from the

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NET FOREIGN AND PORTFOLIO EQUITY INVESTMENT  
(\$BILLION)

	1991	FDI 1992	1993	1994	1991	PEI 1992	1993	1994
Algeria	-38.7	3	-2	0	0	0	0	1
Bahrain	-6.9	-8.5			-34.6			
Egypt	140.5	358.7	453.0	500.0				
Iran								
Iraq								
Israel*	-73.0	-112.1	-373.6	-420.5	548.4	-740.1	1750.3	2378.4
Jordan	26.0	45.0	20.0	25.0				
Kuwait*	-186.4	-1210.7	-848.1	-1074.5	-601.5	272.8	163.3	
Lebanon			902.0	1198.0				
Libya								
Mauritania	2.3	7.5	16.1	2.8				
Morocco	319.9	423.6	492.5	660.0	0	0	29.9	
Oman	149.0	87.4	98.8					
Qatar								
Saudi Arabia	160.2	-79.3	-79.3		-470.0	-3645.7	-8448.1	
Sudan								
Syria								
Tunisia	140.5	364.1	238.1	187.8	20.5	46.4	17.9	14.8
Turkey	783.0	779.0	622.0	559.0	623.0	2411.0	3917.0	
UAE								
Yemen	583.0	719.0	903.0	17.0				

Source: IBRD, *World Bank World Data 1995*, CD-ROM

Note: Negative, net direct foreign investment is due to outward investment:  
Israel - (1991) \$423.5mm, (1992) \$650.7mm, (1993) \$928.5 mm, (1994) \$826.2mm;  
Kuwait - (1991) \$186.4mm, (1992) \$1210.7mm, (1993) \$848.4mm, (1994) \$1074.5mm.

THE ROLE OF DIRECT FOREIGN INVESTMENT 1986-91  
FDI/GDCF - %

Middle East		Others - Europe	
Egypt	7.80	Belgium	16.00
Oman	6.90	United Kingdom	14.40
Tunisia	3.50	Netherlands	12.30
Morocco	2.60		
Jordan	1.70	Others - Far East	
Yemen	0.90	Singapore	29.40
Sudan	0.10	Hong Kong	12.10
Algeria	0.05		

Source: *Comet*, 41 (July 1994): 12.

Notes: FDI - Foreign direct investment  
GDCF - Gross domestic capital formation

European Union<sup>7</sup> – is made available, genuine economic development seems unlikely to occur in any sense that will guarantee generalized economic growth in the countries concerned. Under present plans, the danger is that the alternative will be that enclave economies will be created in South Mediterranean states, designed to serve the European market and that the national economies will merely become states of the European Union without experiencing genuine economic development and the prosperity which should accompany it.

Yet, if the terms offered for foreign private investment have improved so significantly over the past decade and investment still does not come except to the oil and gas sectors in the amounts anticipated, then the reason must lie in other factors than the direct legal status conferred on foreign investment. Some of these problems are general to the whole phenomenon of foreign investment; other arise specifically from the conditions which exist in the Middle East and North Africa. As will be discussed below, the roots of these problems and difficulties reside largely in social and political issues, rather than in the directly economic sphere a consideration which underlines the urgent need for political and social reform throughout the region. At the same time, regional stability plays its part and outside actors, such as the European Union, need to pay far greater attention to participating actively in the resolution of regional problems, such as the continuing tensions between Israel and the Arab world, particularly with respect to the Palestinian issue, or the worsening crisis in Algeria.

### **The General Problems**

One major concern arises for the status of foreign property rights. This is the question of providing legal guarantees of ownership to foreign nationals investing in a particular country. Since the original owner is, by definition, non-resident, he has little recourse except to withdraw future investment, if his investment is appropriated by legal or illegal means. It is an age-old problem that exists largely because few generalized instruments exist in international law to maintain such property rights and international law, itself is virtually without sanction against states and legal entities within them, except by agreement of the state concerned. Furthermore:

... foreign property rights grew out of reciprocal interests, but...they were one-sidedly extended to the developing countries. The capital exporters laid down the 'rules of the game'; the capital importers sought to undermine them. At first, the latter sought to establish the right not to be subject to military intervention at the time of investment disputes. Subsequently, they struggled for the right to nationalize foreign-

controlled, for whatever gains. By diplomatic co-operation developing countries gradually undercut the traditional property rights.<sup>8</sup>

Interestingly enough, one of the major efforts made by Western states since 1990 has been to enshrine foreign property rights in the legislation of both developing countries (including countries in the former centrally planned economies group) and to do the same in international fora. At present, a major row is developing between developing countries and the developed world over the latter's proposal to include a foreign investment code in the legislation of the World Trade Organisation – the Multilateral Investment Agreement that has been temporarily shelved as a result of French objections. This would allow for open access, whatever national legislation might dictate. It is being strongly resisted by developing countries, including Egypt. However, the countries concerned also need to recognize that their own legal systems are defective as far as the foreign investor is concerned, because their deficiencies increase the political risk of investment – despite recent initiatives to accept international procedures over litigation and dispute resolution.<sup>9</sup> This has a particular relevance to the issue of intellectual property rights, an area to which relatively little attention has been paid by South Mediterranean governments. Perhaps most immediate in this respect, however, is the continuing danger of state expropriation of private foreign assets, given the role of hydrocarbon investment in the region. Despite current assumptions that the era of nationalization has disappeared, the very nature of mining operations means that it is bound to re-emerge in the future and attention should be paid to this particular problem now, if the tensions and crises of the 1970s oil shocks are to be avoided next time round.

### *The Obsolescing Bargain*

This problem gives rise to another, more specific issue: the 'sanctity of contract'. Foreign investors are anxious to be certain that a contract once entered into, will not be subject to change under pressure from domestic legislation. The classic dilemma in this respect is also best illustrated in the oil and gas sector which is subject, as are other mining operations, to the 'obsolescing bargain'. This provides for the fact that, when such an operation is planned, the risk of failure is clearly high for there is considerable uncertainty of profitable discoveries. Contract terms clearly have to reflect the high level of risk involved that the investment be unprofitable to both sides. However, once discovery has been made and exploitation has started, the risk element in the investment will have dropped significantly and the terms of the original contract seem increasingly unfair to the host country which sees the proportion of rent it receives as being unreasonably low in consequence.

Such contracts are notoriously subject to unilateral demands by host countries for change, demands which are often backed by the weight of domestic law and thus cannot be resisted. Although foreign investors attempt to allow for this by the inclusion of so-called 'stabilization clauses', the fact is that these can hardly ever be sustained against determined attack by the host country. This in-built lack of stability in the sanctity of contract is, of course a powerful dis-incentive to investment and its logical conclusion is nationalization. This, in turn, generates another problem for the foreign investor; namely, the mode of compensation he is to receive for his nationalized asset. International law demands that compensation should be 'fair and just'.

The problem is that there is no agreement on what these terms mean. The United States, supported by most developed states, has insisted that this term should be interpreted to mean the full value of the asset, as determined by discounted-cash-flow principles – as if the asset in question were to be valued for the purpose of private purchase. Developing countries have argued that net book value or some variant thereof is a fairer alternative. International tribunals have yet to establish what the standard of compensation should be.<sup>10</sup> The same problem, of course, exists in an attenuated form with non-oil properties, where it is known as 'the changing balance-of-power problem'. Furthermore, although nationalization as a technique in the hands of developing countries has declined significantly in recent years, there is every reason to suppose that, in a few years time, the problem will arise once again as developing countries perceive themselves to be unfairly disadvantaged by modern international investment codes, whether or not they are members of the World Trade Organization.

#### *The Political Dimension*

These problems are all rendered more acute by political considerations. One typical problem is that of sovereign immunity; namely when foreign entities are protected by their own governments so that a host state has to deal with another state in any dispute with an investor. This used to be a serious problem in the past and has slackened in recent years, largely because of customary international law. Nevertheless, treaty obligations can create such a situation in specific cases and with specific countries. The reverse of this problem is that of sanctions which renders foreign investors leery of what might otherwise be major investment opportunities which meet all other investment criteria.

The classical example of this type of problem is provided by the Helms-Burton and D' Amato-Kennedy legislation – better known as the Cuba Sanctions Act and the Iran-Libya Sanctions Act (ILSA) – in the United States which seeks to enshrine the principle of legal extra-territoriality for American

federal law. The other typical example is the role of the United Nations or individual states in imposing sanctions on states such as Libya, Iran or Iraq. It should not be forgotten, for example, that a major investor in Egypt is Libya – which suggests that Egypt itself might fall under the constraints of American extra-territorial legislation or, until they were removed from Libya, United Nations sanctions, with all that that might imply for foreign private investors there. In effect, sanctions are considered by investors to be an unreasonable interference in legitimate economic activity but they are forced to comply because of the potential penalties under domestic legislation in the states applying sanctions.

Even United Nations sanctions operate under a similar legal regime. Investors face another problem, however these circumstances. This is that the host country for the investment may also levy penalties if the investor observes home country or third country legislation. Such penalties can involve financial loss, retention of profits or nationalization. Thus, investors tend to make careful evaluations of political risk in this case external political risk – as part of the basic investment decision. Often such calculations are absorbed into the proposed discount rate used to calculate expected returns and the financial value of the asset and this, in turn, can lead to problems over the 'obsolescing bargain'.

External political risk, however, is only one part of the political evaluation process. Two other aspects are of considerable interest to the investor and make their way into the discount rate. The first of these relates to the simple – and non-legal – question of political stability, clearly important in terms of the likely longevity of the investment. It does not follow, incidentally, that political instability disqualifies a particular country from receiving foreign investment, as is shown in the case of oil and gas investments in contemporary Algeria. It does, however, raise issues of legal continuity of sanctity of contract, hence the interest that potential investors take in consulting both governments and their oppositions! The most important aspect of political risk, however, is the actual status of a domestic legal code within the structure of a particular political regime. Ideally, governmental behaviour should be subject to the rule-of-law. In practice, however, this is often not the case, whatever governments may pretend. As a result, investors recognize that the process of investment becomes subject to the vagaries of governmental or individual whim. The most obvious example of this is the question of corruption, a widespread problem in the Middle Eastern and North African region.

Associated with this issue are the companion issues of corruption, smuggling, drugs and crime. They can all affect the status and effectiveness of domestic legislation and may even have more direct effects on investment. Governments, of course, try to respond, to the extent that they are able, given

their own subjugation to the same problems. Sometimes, this can produce acute tensions within government, as some analysts allege occurred in 1971 in Morocco and as is said to have occurred in Tunisia in 1995 and, most particularly, in Algeria. Sometimes, it can result in campaigns designed to correct the original problem which incidentally also severely affect the investment climate. Something of the sort appears to have happened in connection with the Moroccan anti-drugs and anti-smuggling campaign in 1996. This may also turn out to be the case with the 1997 Moroccan anti-corruption campaign, simply because of the uncertainty it may introduce into the political process.

### **Law and Governance**

One of the consequences of the Euro-Mediterranean Partnership initiative will eventually be to increase the significance of agreed standards of what the British government has called 'good governance'. By this term is meant the institution of governmental systems that are subject to the rule-of-law and do not engage in repression as a means of retaining power, being instead responsive and accountable to public pressure and to agreed norms of government. This will inevitably improve investor confidence as the level of transparency they require, both in commercial and political terms, will follow on from the creation of legal and judicial regimes which genuinely independent of the state and governmental structures. In this context, therefore, the political and security basket of the Barcelona Process had an immediate and important relevance to improving investor confidence and thus rendering the system introduced by the economic basket more viable.

Indeed, this issue highlights a profound difference between Europe and the United States over the ways in which political and economic transparency and accountability can be achieved. Europe generally argues that political initiatives are necessary to achieve this; government itself must be made accountable and, in a word, more democratic. This then leads to objective legal process and transparency which creates the conditions for sustained private investment. The American and – to some extent – British view is different. Here it is argued, along the lines of the 'economic theory of politics',<sup>11</sup> that the transparency imposed by the commercial world leads inexorably towards political transparency and accountability. Thus, through economic liberalization and the creation of appropriate legal structures to encourage this process, political liberalization will eventually be forced on reluctant governments – as occurred, for example in Chile.

In the South Mediterranean region, in reality, a combination of both processes is likely to force democratic change. The Barcelona Process, with its emphasis on eventual political change, largely because of regional security

concerns if such change is not accomplished, is certainly one source of pressure, although its effectiveness will depend on the extent to which the European Union is willing to make it a priority within the Euro-Mediterranean Partnership initiative. At the same time, the economic changes being forced on South Mediterranean states as part of the transition process involved in the creation of the bilateral industrial free trade areas, will create their own imperative for legal change. One good example is the changes now required in customs tariff regimes and in domestic fiscal systems. The phased reductions in tariff barriers, which is an integral part of the free trade area process, will force governments to look for new sources of revenue, given the current importance in state finances played by tariffs. This will be buttressed by the introduction of Value Added Tax, as the main means of indirect taxation in most of the South Mediterranean countries as a result of World Bank pressure. This, in turn, will undoubtedly intensify social unrest in many states because VAT is a far more universal tax than most systems currently in place – and this, in turn, will force governments to become more responsive to public opinion unless they wish to face increasing political instability and consequent declines in foreign investor confidence.

Of course, this in part depends on the type of investment being made. It is notable, for example, that major investments in hydrocarbon assets seem to escape most of these political requirements entirely. It is as if either international oil companies do not bother over political risk, being uncertainty of economic return from investment, or consider that political risk is minimized by the fact that any government in whose territory they work will depend on access to oil rent to ensure its own survival. This certainly seems to be the case in Algeria currently, for example, where the British company BP has been prepared to risk a massive investment of \$3.5 billion in political circumstances which are highly unpredictable. International oil companies are, in short, far more concerned about the misuse of the 'obsolescing bargain' and the threat of eventual nationalization than they are over issues of legal and political transparency and accountability.

For non-oil investors, however, this is not the case. They rely heavily on guaranteed political stability and legal transparency to ensure the predictability of the security of their anticipated return on investment. In their calculations of political risk, therefore, effective and independent legal structures are of crucial importance. They must also consider the ways in which other aspects of the Barcelona process are likely to affect investment. There is certain to be growing pressure for greater observance of human rights standards in the countries of the Southern Mediterranean, both from domestic and foreign sources, as the process of government accountability develops.

This is also likely to be partnered by growing domestic concerns over environmental and ecological issues – as was seen in the early 1990s, when a

Canadian company proposed waste dumping in the Western Sahara, only to see its contractual arrangements revoked by the Moroccan government. Similarly, consumer concerns over issues of labour abuse, which will be partnered by pressure from labour organizations in Europe because of the economic as well as the human rights implications, are bound to lead to increasingly complex patterns of legal controls over the freedoms of foreign investors, as will World Trade Organisation vigilance over the potential for economic dumping in European markets – although the comparative labour cost advantages of North African and Middle Eastern producers is likely to decline as development proceeds. None the less, the advent of government transparency and accountability will – certainly if it is accompanied by genuine economic development – result in a more complex legal framework for foreign investors, both guaranteeing their interests and circumscribing their freedoms of action – just as is the case in Europe!

#### **Conclusion and Recommendations**

The problems facing investment host countries as far as the legal status of investment is concerned fall into two groups. The first is one connected with the status of investment under international law and in the context of the 'obsolescing bargain'. This, in theory, could be dealt with through an international investment code operated by the World Trade Organisation and designed with the concerns of the developing world in mind. However, given the legal recognition of the sovereign immunity of states, difficulties reflecting differing perceptions of the inherent values of contracts will continue and the danger of nationalization will remain.

The second reflects the international political processes of host countries and the role played by domestic legal systems, particularly their independent status from government or regime. Unless such independence exists and is perceived to exist by potential investors, private investment will be discouraged. The process of investment thus links in to the problem of 'good governance' and thus forms an integral part of the Euro-Mediterranean partnership project. It remains to be seen to what extent both North and South Mediterranean partner-states are prepared to recognize the core role of the independent legal process, both in terms of political and economic development, and to what extent either side is prepared to confront the issue.

Of course, none of these developments will occur simply by themselves. To a large extent, the Euro-Mediterranean Partnership initiative should attempt to expand the role of its political and security basket to encourage the development of independent legal systems and transparency in the legal process. In part this will follow on from the process of democratization. However, there will also be a need to ensure that national legislation meets

accepted international commercial legal standards. Care should also be taken to try to foster appropriate legislation to ensure that foreign investors cannot exploit labour, social and environmental legislation to their advantage. Above all, South Mediterranean governments should be encouraged to accept the crucial importance of effective and independent legal systems, untainted by official interference. Such changes require active European Union involvement and aid. It is unlikely that the MEDA programme, which forms part of the Euro-Mediterranean Partnership initiative will be able to provide such aid and consideration should be given to providing special funds – similar to the British government's 'know-how' fund for Eastern Europe.

There are also specific measures that could be considered by the European Union as part of its follow-up process to the Barcelona Conference in 1995. They relate to issues raised above:

- (1) South Mediterranean governments should be encouraged to improve the status of foreign property rights in their countries by both improving legal protection provisions and arbitration procedures. These should be brought into line with European standards.
- (2) Attention should be given to developing common standards and modes of compensation across the Mediterranean, both in the case of dispute and in the case of nationalization of foreign assets. Although this problem may appear to be remote at present, the very nature of the obsolescing bargain will force it to the forefront of the political and diplomatic stage by the early decades of the next century.
- (3) European governments need to reconsider their views on the future role of economic sanctions in international relations, because of the adverse effects such regimes have on investor confidence – not just for the countries concerned, but for the region overall. This really forms part of the problem of political conditionality which still needs to be addressed within the context of the Barcelona Process.
- (4) It is becoming increasingly clear that there is a close link between economic improvement and political change, particularly as far as attracting foreign investment is concerned. Thus the European Union should give greater prominence to encouraging increased 'good governance' as well as political transparency and accountability, as part of progress on the economic basket of the Barcelona Process.
- (5) At the same time, the changes in tax structures required by the free trade area proposals will cause shortfalls in government revenues at a time

when adjustment will demand greater government expenditure on economic restructuring. The European Union should direct additional resources at easing this transition because of the adverse social consequences if this is not done, particularly in respect of restructuring fiscal systems and tax collection mechanisms.

- (6) Environmental and ecological issues should be addressed by persuading South Mediterranean states to adhere to international conventions, particularly the convention on climate change, and to incorporate 'best practice' style legislation on environmental protection into their national legislations, so that common standards apply across the Mediterranean region.
- (7) Similar 'best practice' style legislation should also be encouraged in terms of labour legislation and trade union legislation, even if this might imply a reduction in apparent comparative advantage, as this will tend to stabilize the political and social situation and will thus work to the benefit of the foreign investor in the medium to long term.
- (8) In return for such adjustments, some of which will further erode the comparative advantage of the South Mediterranean region to foreign investors, the European Union should undertake to enforce appropriate legislation on a global basis through the World Trade Organisation.
- (9) Foreign investors should also be encouraged by the provision of investment insurance systems, similar to those already provided by the World Bank, for investors in the South Mediterranean region. These should be in addition to insurance schemes already provided at a national level in Europe.
- (10) In view of the increasing integration of North Africa into the European gas grid distribution system (via the TransMed and Trans-Maghreb pipeline systems), attention should be given to similar integration of electricity supply systems. This would provide an opportunity to stimulate investment into solar energy production in North Africa and the Middle East for electricity export to Europe.

Behind these considerations, there lie a set of essentially self-evident principles designed to ensure that foreign investors encounter stable and reproducible environments for investment, typified by the concept of the rule-of-law. Judicial systems must be independent of government in every meaningful way and government itself must be subordinate to established

legal codes. This, in turn, implies that government must be committed to the principles of 'good governance' as generally understood to combine political participation and accountability to ensure social justice. More specifically, legal systems relating to commercial and financial activity must be transparent, simple and enforceable to be credible – the example of Egypt with its 65,000 laws, often in contradiction with each other is a case in point. Above all, the legal codes and system must be equitable, particularly in providing equal treatment to nationals and foreigners alike, whilst being reproducible, in that they are not subject to change at government whim but only by due process. The creation of a legal environment of this kind will do much to ensure that foreign investors see the Middle East and North African regions as viable investment destinations in future and it is that that should become one of the major objectives of the Barcelona Process.

NOTES

1. J. Ould Aoudia (1996), 'Les enjeux économiques de la nouvelle politique méditerranéenne de l'Europe', *Monde Arabe: Maghreb-Mashreq*, 153, July-Sept. 1996, p.33
2. G. Bannock, R.E. Baxter and K. Rees (1978), *The Penguin Dictionary of Economics*, Harmondsworth: Penguin, p.189
3. The process whereby foreign investors are required to either take an indigenous partner, who is often the majority shareholder in a joint venture and thus can threaten the security of an investment, or are required to integrate local staff regardless of their levels of competence, as part of a process of assumed 'technology transfer'.
4. See, for example, J.S. Lizondo (1991), 'Foreign Direct Investment', in *IMF Determinants and Systemic Consequences of International Capital Flows*, Occasional Paper 77, March 1991, pp.68-77.
5. E.G.H. Joffé (1992), 'Foreign Investment and Economic Liberalisation', *JIME Review*, 17 (Summer 1992), pp.24-5.
6. Aoudia, op. cit., pp.30-31.
7. European Union Official Development Assistance ran at four per cent of total aid for the South Mediterranean states between 1990 and 1993, rising to 29 per cent once bilateral official aid from European states was included. The Maghrib received the equivalent of \$29 per head, whilst Israel, Egypt and Jordan received \$90 per capita. However, in the Mashreq, Europe's role was even more restricted than in the Maghrib, providing only three per cent of multilateral aid from the European Union itself and 19 per cent, once bilateral official assistance was included (See Aoudia, op. cit., pp.24-5.)
8. T. Andersson (1991), *Multinational Investment in Developing Countries: A Study of Taxation and Nationalization*, London and New York: Routledge, pp.11-12.
9. Aoudia, op. cit., p.33
10. For a detailed discussion of this issue with respect to oil and gas properties, see E. Penrose G. Joffé and P. Stevens (1992), 'Nationalisation of Foreign-Owned Property for a Public Purpose: An Economic Perspective on Appropriate Compensation', *The Modern Law Review* 55/3 (May 1992).
11. See, for example, A.O. Hirschman (1981), *Essays in Trespassing: Economics to Politics and Beyond*, Cambridge and London: Cambridge University Press and A. Foxley, M.S. McPherson and G. O'Donnell (1986), *Development, Democracy and the Art of Trespassing: Essays in Honor of Albert O. Hirschman*, Notre Dame, IN: University of Notre Dame Press.