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The Effectiveness of international investment instruments on the amount of foreign investment (a case study of Iran)

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Subject:

The Effectiveness of international investment instruments on the amount of foreign investment (a case study of Iran)

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Glossary of Abbreviations:

BIT: Bilateral Investment Treaty

DTT: Double Taxation Treaty

FDI: Foreign Direct Investment

FIPPA: The Foreign Investment Promotion and Protection Act

IRI: Islamic Republic of Iran

LAPFI: The Law on Attraction and Promotion of Foreign Investment

NIOC: National Iranian Oil Company

OECD: Organization of economic cooperation and development

OIETAI: Organization of Investment and Technical Assistance of Iran

UN: United Nations

UNCTAD: United Nations Conference on Trade and Development.

UNSC: United Nations Security Council

Abstract:

This is an analytical study which aims to gauge the extent to which international treaties have been effective in directing foreign investment to Iran. The two types of treaties studied here include Bilateral Investment Treaties and Double Taxation Agreements. Data as to the amount of investment in Iran as well as some information regarding the domestic investment regulatory framework in Iran is presented. The country has experienced widely different attitudes towards investment in the last 30 years because of its domestic political changes and, of course, in response to international developments. Upon recovering from the initial nationalistic shock of the 1979 revolution, Iran has engaged in many international instruments in the last 15 years and has also made several changes to its domestic fiscal and investment laws to provide foreign investors with a more favourable investment climate. These attempts have partly succeeded in the sense that there has generally been an upward trend in the amount of foreign investment channelled to Iran since 1994. This amount, however, is still much lower than is the norm for a country of the size and natural resources of Iran. Through investigating different impediments to foreign investment in the country, the study finds that overwhelmingly political and non-legal factors such

as the relationship between Iran and the West and the attitude of the Iranian administrations to international trade carry much greater weight than merely concluding treaties. Despite this, the number of treaties concluded could be a good indicator of the political climate of the country at any given time and it can be seen that the government's plans for attraction of foreign investment have always been clearly more successful throughout periods when more treaties were signed.

Key words:

Foreign direct investment in Iran, Bilateral investment treaties, Double taxation treaties, impediments to foreign investment in Iran, Foreign Investment Promotion and Protection Act of Iran

Introduction:

Foreign investment is held to play a vital role as far as economic growth is concerned. Most studies reveal a significant endogenous relationship between FDI and economic growth; foreign direct investment among all types has been established to have the strongest impact of all[1]. We should add to this the positive externalities of such investment such as transfer of technology. Most developing countries need to compete for foreign investment as they lack the necessary financial resources internally. However, as historical records indicate, developing countries have not exactly been safe havens for foreign investors and very many disputes have historically arisen out of cases in which developing countries were involved as the host country.

The means of attracting foreign investment are not exclusively legal and include a wide array of subjects such as political stability, a high standard of security and of course a favourable tax regime. However, legal steps towards attracting foreign investment have usually involved concluding international treaties with Capital exporting states as well as making reforms to the domestic legal and tax regimes thus turning them

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[1] Robert, E. Lipsey, (1999). "The Role of Foreign Direct Investment in International Capital Flow" NBER Working Paper No. 7094.

into a more favourable setting for international investors. On the international level, a wide range of international treaties are possible. Two main types are bilateral investment treaties and double taxation treaties.[2] Bilateral investment treaties are by far the commonest types of such treaties usually, but not exclusively, concluded between developing and developed countries which mainly aim to grant foreign investors, national to the treaty countries, more assurance as to the security and protection of their investment. They also aim to grant them access to fair dispute settlement mechanisms.

However, from a perspective, through concluding a BIT a developing country is in fact making a compromise on its sovereignty in the hope that they can achieve a questionably more important end which is attracting foreign investment. Intriguingly, BITs are effectively based on principles that developing countries have long been historically objecting to [3] . Another widespread international instrument, most commonly referred to as double taxation agreements, could also be a part of a government's scheme to create a more attractive climate for investment.

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[2] It should be noted that treaties with an aim to encourage foreign investment are really diverse and these two are merely chosen as common types that many countries have used as an instrument to encourage foreign investment. Other treaty types may include: Trade treaties, preferential trade treaties, bilateral customs agreements, treaties on foreign investment aid etc.

[3] Kenneth J. Vandevelde, "The Economics of Bilateral Investment. Treaties", Harvard International Law journal 41 , (2000): 469.

Nevertheless, in a DTT as is usually the case, developing countries, as investment importing countries often have to forgo part of their tax revenue so as to provide incentive for foreigners to make investments within their territory.

Iran, particularly as an oil producing country, is in crying need for big amounts of foreign investment especially in its energy sector, mainly to expand or even maintain its current oil and gas production level. Attracting foreign investment has becoming one of the main sources of funding for the governments of Iran in the previous 15 years. There have been sweeping changes made to the domestic regulatory framework of the country and many of the previously burdensome regulations have been reformed. In fact, the country enjoys a much more investment friendly atmosphere than it previously did. On the international level also, there have been developments; Iran has shown more inclination towards investment relevant international treaties and has signed quite a lot of these treaties as well. Despite the evident increase, however, there is debate as to whether these measures have been fully effective or not. It is argued that the amount of foreign investment channelled to Iran is still relatively insignificant considering international standards. This

proposition holds true when the larger picture is looked at, but a closer look at the trend of foreign investment reveals that there have been fluctuations and a chronological study can best capture the essence of these variations.

This study aims to assess the effectiveness of the two mentioned international instruments for attracting foreign investment. The focus of the study, despite covering much information on international investment, would geographically lie on Iran and, therefore, a great deal of information about the climate of foreign investment in the country is deemed essential.

Research Questions:

The study attempts to find answers to four main questions:

1. Is foreign investment an effective factor in terms of economic growth and development? (Literature Review)

2. Do bilateral investment treaties and double taxation agreements encourage foreign investment? (Literature Review)

3. Has Iran experienced a noticeable increase in FDI since it started concluding such agreements in the 1990s and, if so,can these increases, if any, be attributed to the mentioned treaties?

4. How could Iran meet its need for FDI and what are the impediments to attraction of foreign investment in Iran?

Methodology and chapters:

This is an analytical study with its focus mainly on Iran. It is not an empirical study, but reference is regularly made to findings of other surveys of economic nature. The first chapter lays the ground work by addressing the first questions of the study through a brief review of the relevant literature. The concept of foreign direct investment and its links with economic growth are looked into. As well as this a number of factors that could influence FDI inflows will be briefly highlighted is a short section.

The second chapter focuses on Iran and starts by giving a rather detailed historical account of foreign investment in Iran. The historical study is organized in a chronological order with due regard for particular political features of each time era. Data as to the state of foreign investment in Iran is presented in Graphs and tables at the end of this chapter. Along with this, the basis of the domestic regulatory and legal framework of the country concerning foreign investment will be introduced.

In the third chapter, international treaties used to attract foreign investment are discussed. Apart from introducing the two relevant international instruments namely BIT and DTT, information regarding the treaties signed by Iran will be provided.

In the Fourth and final chapter, the main impediments to foreign investment in Iran are listed and expounded duly. Finally, a conclusion will follow to sum up the study and answer the research questions specifically. Recommendations are also made as to what measures the government should take so as to maximize its FDI inflows.

Chapter one: Foreign direct investment

1-1.Definition of foreign direct investment:

The Encyclopaedia of public international law defines investment as 'a transfer of funds or materials from one country (called capital exporting country) to another country (called host country) in return for a direct or indirect participation in the earnings of that enterprise'. This definition has been criticized as too broad.[4]

UNCTAD 1999 defines FDI as 'an investment involving a long term relationship and reflecting lasting interest and control of a resident entity in one economy in an enterprise resident in an economy other than that of the foreign direct investment'[5]. Very similarly, the International Monetary fund's *Balance of payments manual* defines FDI as 'an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise'[6]. These latter two definitions aim to clearly exclude portfolio

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[4] M. Sornaraja, The International Law on Foreign Investment, (United Kingdom, Cambridge university press, 2004), 7.

[5] UNCTAD "World Investment Report: Foreign Direct Investment and the Challenge of Development" (1999) (New York: United Nations).

[6] M. Sornaraja, The International Law on Foreign Investment, 8.

investment through using words such as ‘control’ and ‘controlling interest’.

Foreign direct investment should include a transfer of property from one country to another. In the case of portfolio investment, however, there is no participation in management of a company and, therefore, not as much risk is borne by the foreign investor.

Historically, the definition of the term investment has grown broader in the course of time initially through the inclusion of intangible property. The inclusion of company shares in the definition of investment in many bilateral treaties following the Barcelona Traction [7] case has risen questions as to whether portfolio investment should be included in the protection awarded by bilateral investment treaties or not, which is still a matter for debate.

1-2.A short history of FDI:

There is a long history of FDI in Europe going back to very early times. Initially, two main doctrines evolved one stressing national treatment for foreign investors another requiring an international standard which is, amusingly, still a heated controversy. [8] In modern history particularly

[7] (ICJ) case, Belgium v. Spain (1970).
[8] M. Sornaraja, The International Law on Foreign Investment, 21.

beginning in the eighteenth and the nineteenth century, foreign investment often took the shape of Britain financing the economic development of other countries and was merely a form of colonial expansion. During that time, there was no need for an investment law because of the integration of the colonial legal systems.[9] Outside this colonial context, power played a crucial role; Britain lost its status as the main global creditor to the United States in the interwar period as the US started becoming a world power. Another development in the same era was the decline in international trade and the proportional increase in direct investment. Prior to the World War II, the need for the development of some international law doctrine was felt in the context of American investment in Latin American countries which involved many clashes. After the world war the amount of foreign direct investment grew sharply in the world mainly because there was a great need for foreign capital in the severely damaged European countries as well as Japan. This need was mostly met by the US. Another reason for this growth was technological achievements which made international investments much more easily feasible.[10] US remained the world leading

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[9] Ibid, 19.

[10] . Imad A. Moosa, Foreign Direct Investment: Theory, Evidence and Practice, (2002, Palgrave publication, United Kingdom), 17.

capital exporter until 1980s when it itself became a big recipient of FDI mainly from Japan and Germany. An important development in the last two decades of the twentieth century was an increase in the share of FDI directed to less developed countries. Akrami Moghadam (2000) cites three main reasons for this increase:

1. The pressing need of developing countries for foreign investment.

2. A change in the mindset and the attitudes of the developing countries towards foreign investment.

3. Globalization of products and services.

In fact, FDI worldwide increased from 14 percent in 1980 to 26 percent in 1997[11]. Despite the increase, the distribution of FDI between the less developed countries is not even and not all of them have captured a big significant share.

1-3. Determinants of FDI:

To find out why FDI is likely to be channelled to certain regions and countries and not equally to others can only be described if effective factors in attracting FDI are known. These factors are those that Multi

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[11] Leyla sarafraz, "Economic Reforms and Foreign Direct Investment in Iran" REPEC working papers May 2002, http://mpra.ub.uni-uenchen.de/1480.

National Companies (MNC) take into consideration when making investment decisions. Since investment is a long term and costly process, MNCs consider numerous economic and country specific criteria when weighing up their investment options.[12] There have been changes in the trends and important factors and incidentally those that have become increasingly more important are those that contribute more to economic growth.[13]

These factors have generally been categorized into five broad classes:

“1. General policy factors (e.g. political stability, privatisation)

2. Specific FDI policies (incentives, performance requirements, investment promotion, international trade and investment treaties)

3. Macro economic factors (human resources, infrastructure, market size and growth)

4. Firm specific factors (e.g. technology). ”[14]

The present study mainly deals with general policy factors, which include national policy decisions, and specific FDI policies which entail

[12] Jason Lewis, "Factors Influencing Foreign Direct Investment in Lesser Developed Countries" *The Park Place Economist*: 8(2000).

[13] Dirk Willem te Velde, “Foreign Direct Investment and Development An historical perspective” 2006, http://www.odi.org.uk/resources/download/594.pdf.

[14] Ibid.

changes made to the domestic legal and fiscal framework in Iran as well as investment treaties.

It seems that among Macro economic factors market size and human resources are the most important ones; (Obadan 1982; Anyanwu's 1998; Iyoha 2001) all doing case studies on Nigeria, find market size and technological infrastructure to be the most important determinants in attracting FDI . However, (Dinda 2009) emphasizes the increasingly important role of natural resource wealth and trade partners for attraction of foreign investment. This is confirmed by the findings of (Asiedu 2002, 2006).

1-4.Effects of FDI on economic growth:

The views on the effects of FDI on an economy are incredibly diverse including a very wide spectrum on one side of which it is considered as a form of new colonialism, while on the other it is thought to be absolutely indispensable to the economy of the host state.[15]

The states which participated in the Paris Conference on International Economic Cooperation, held in 1963-1964, acknowledged that foreign

[15] Xiaoying Li, Xiaming Liu, "Foreign Direct Investment and Economic Growth: An Increasingly Endogenous Relationship", World Development 33, no 3(2005): 393.

private investment inflows play a crucial complementary role in the process of economic development, especially through "the transfer of resources, managerial and administrative expertise and technology to the developing countries, the expansion of productive capacity and employment in those countries and the establishment of export markets."[16]

What makes FDI unique is that it continues to expand even when the world trade is down. Unlike portfolio investment, FDI does not suffer a serious decrease as a result of many financial crises.[17] In fact, FDI has been the least volatile among international investment sources. [18]

Foreign direct investment is thought to bring about numerous benefits to the host state. In general several studies (Caves, 1974; Kokko, 1994; Oulton, 1998; Blomstrom and Sjoholm, 1999; Xu 2000) confirm that there is a positive correlation between FDI and productivity. (Blomstrom *et al.* 1996) finds that FDI leaves a strong positive effect on economic growth. (Xiaoying Li and Xiaming Liu 2004) finds an endogenous

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[16]Department of Economic & Social Affairs (Editor) United Nations Model Double Taxation Convention Between Developed and Developing Countries, (United Nations Publications, 2001), 23.

[17] Imad A. Moosa. Foreign Direct Investment; Theory, evidence and practice, 16-18.
However, this appears to be contestable. For example, During the Argentina crisis in 2000 the FDI did suffer and generally global FDI movements plunge during global financial crises.

[18]Robert. E. Lipsey. The role of FDI in international capital flows.

relationship between FDI and economic growth using a panel of 84 countries during 1970-1999. It should be noted, however, that (Laura Alfaro 2003) using a cross country panel finds that FDI growth affects the primary, manufacturing and service sectors differently; while FDI growth in the primary sector impacts the economy negatively, there is a positive impact in the case of manufacturing and an ambiguous effect when services are concerned. Besides, some studies find that FDI has a potentially greater effect on economically developed countries compared to less developed countries.[19]

In addition to providing direct capital financing, FDI can produce positive externalities such as technological spill-over for the host state. However, again these positive externalities may be conditional upon the development of financial markets and the level of education in the country[20]. In summary, most economic models attach much value to foreign investment.[21]

An investigation of the growth of investment in recent years especially the last two decades signifies that developing countries have come to accept the positive effects of investment on their economy so much so

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[19] Laura Alfaro and others. "Does Foreign Direct Investment Promote Growth? Exploring the Role of Financial Markets on Linkages" http://www.people.hbs.edu/lalfaro/fdiandlinkages.pdf.

[20] ibid.

[21] Hooshang Amir Ahmadi, Weiping Wu, "Foreign Direct Investment in Developing Countries, The Journal of Developing Areas" 28(January 1994) :167.

that the growth of foreign investment has been much faster than the growth of international trade or international products.[22] From 1980 to 1997 foreign investment experienced a 13 percent growth in comparison with a 7 percent growth in international trade. Less developed countries in general lack the resources to advance their development projects. This is mainly why most developing countries have competed for FDI regardless of the findings of empirical studies; Whether a growth in FDI is established empirically to enhance the economy of a country has proved to be of very little practical importance for resource rich countries with heavy economic dependence on their riches like Iran since there are not many other economically viable options.

[22] Farideh Rahmani, "Encouragement of Foreign Direct Investment", Journal of Political and economic information 151-152 , (2000): 164.

Chapter two: Foreign investment and Iran

2-1.History of foreign direct investment in Iran:

To study the history of foreign investment in Iran systematically, a classification can be offered to draw lines between five historically distinct eras.

1. before the revolution (up to the 1979 Revolution)
2. The revolution and war time (1979 to 1993)
3. Reconstruction Period (1993 to 1997)
4. Economic reforms (1997 to present)

2-1-1.Before the revolution:

The initial precedents of foreign investments in Iran can be traced back to the last decades of the nineteenth century when investments were mainly made in The Iranian Petroleum and Northern Fishing Industry by the British and the Russians respectively. Between the years 1881 and 1919 more than 27 concessions were granted to Russians and an estimated 163.75 million Robles worth of investment was made.[23]

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[23]Hossein, Daliri, "The History of Foreign Investment in Iran"[in Persian], Aftab website, August 2, 2008,http://www.aftab.ir/articles/economy_marketing_business/financial_economy/c2c121777109_foreign_investment_p1.php.

During roughly the same period, 1862 to 1913, it was significantly more for the other Iranian major commercial partner, Britain, with more than 217 concessions and an overall of 9.68 million Liras[24]. However, it was during Pahlavi Dynasty and especially in the second Pahlavi's era that the growth of foreign investment in Iran gathered much momentum especially as there was optimum political stability, because of the establishment of the political dictatorship, it might be claimed[25]. The First Iranian Law encouraging foreign investment was passed in the year 1955. The Iranian investment and financial assistance Organization, a huge step towards maximizing foreign investment, was established in 1976.

Finally, FDI in Iran reached its peak during the oil boom, after the first oil shock, between the years 1974 to 1979 when industrial development in Iran was expedited. For example, in the year 1975, in terms of the proportion of foreign direct investment to GDP the country stood in an impressive 49th place among all countries in the world. This compared with its 129th place in the year 2003[26] signifies how important foreign investment should have been to the previous regime. It should be noted

[24] ibid.
[25] ibid.
[26] The Globalis indicator , http://www.globalis.gvu.unu.edu.

that most of the investment during this period was made in industrial machinery. However, all this coincided with the Iranian revolution of 1979 and the fall of Shah. Many have criticized the Shah for his economic policies which included admission of huge amounts of foreign investment and argued that this could lead to foreign control over the economy of the country creating a type of dependence.

2-1-2. the revolution and war period:

The revolution brought about major sweeping changes to the political and economic landscape of the country. As far as foreign investment is concerned, the nationalization of all mother industries in 1979 by the new government, especially given its anti-western attitude, tore down all the infrastructure of investment in the country and sent most foreign investors packing. Merely a year later, The Iraq-imposed eight-year long exhaustive war wreaked havoc on the economy of the country. During this phase lasting up to 1994, the state governed economy of Iran remained quite alien to foreign investment. This period can be characterized by revolutionary idealism and ideological resistance to foreign investment; In fact there were pretty much no laws in force except the nationalization laws which had followed the revolution pertaining to foreign investment. During this period, another important

barrier to investment was US-led sanctions and a lack of political security because of the war in the country. Most investment in the country infrastructure was done by the government without any private assistance. The government mainly used Turnkey contracts for its major infrastructural projects with foreign partners.[27]

2-1-3. Reconstruction Period:

It was not until the start of the second stage in 1994, during the presidency of Ayatollah Akbar Rafsanjani that some legal steps were taken to attract foreign investment. Namely, the 1993 Budget Act legitimized limited amounts of foreign investment[28]. Most of the attempts made throughout this period, however, met only with partial success mainly because the constitutional ban on private ownership of mother industries served as an impediment to attracting foreign investment. The Constitutional ban remained in place up until the year 2002. As well as this, an important development relevant to this field took place during the last years of this phase, however almost on the other side of the planet; Iran-Libya Sanctions Act was passed in the

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[27] , Nima, Nasrollahi Shahri "The Petroleum Legal Frame Work of Iran", 8 China and Eurasia Forum Quarterly 8, no1 (2010), 111-126.

[28] It was in the 1993 Budget Act that the government, for the first time, allowed the NIOC to enter into contracts of up to US$2.6 billions with competent foreign companies provided that several conditions were met.

American Congress in 1996. This Act aimed to forbid any investment exceeding 40 million dollars in the Iranian capital intensive energy sector.

The first signs of pragmatism based on national interest after the revolution began to appear during this period. However, given the national mood of the country after the war, it is now easy to comment that, it should have really been an uphill struggle and, as expected, the plans faced fierce opposition and resistance from different groups within the government body.

2-1-4.Economic Reforms:

The third chronological phase in the history of Iranian investment started from the beginning of the presidency term of Mohammad Khatami in the year 1997[29]. Major economic and political reforms opened new windows of opportunity for foreign investors. The hostilities between Iran and the west were lessened and the gap between Iran and the west appeared much less wide. However, the Iranian nuclear program was revealed to the world during this time and this in itself was enough to distance Iran from the West despite maximum cooperation on the part of Iran with the International Atomic Agency.

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[29] Khatami was the first and last reformist president of the country. He came to power in the year 1997 and was elected president for two consecutive terms, 8 years.

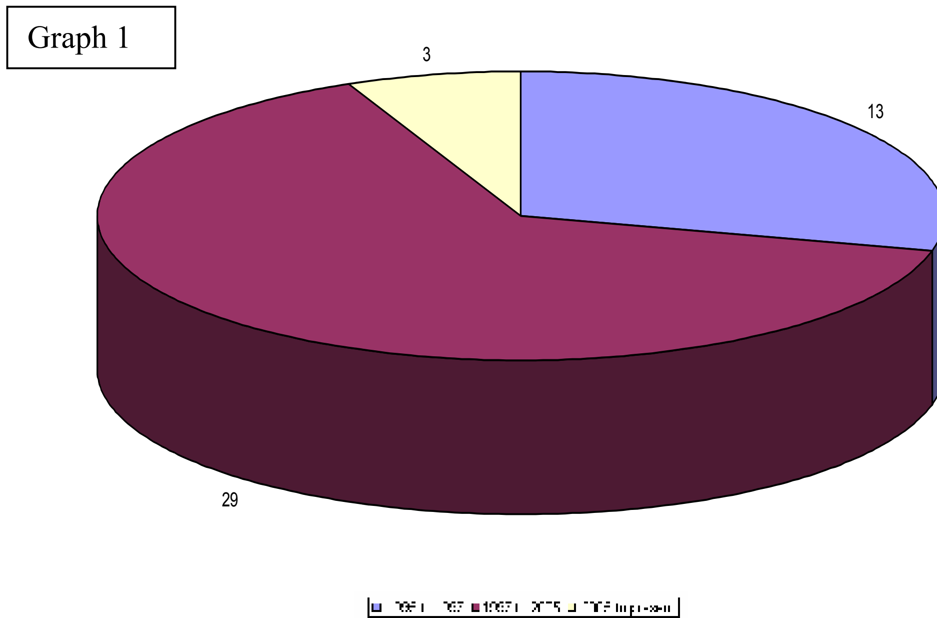
There were changes made to the legal investment framework of the country; a new law, The Foreign Investment Promotion and Protection Act (FIPPA) as will be discussed later in this study, was passed. An arbitration law was passed in the parliament and a flow of foreign direct investment started, however still in very limited amounts compared with international standards. The growth of foreign investment in-flows gathered much speed and reached its peak in the year 2002.[30] It was during this time that concluding bilateral investment treaties with foreign countries accelerated. More than 29 of these treaties were concluded during this era; the pie chart below shows the number of bilateral investment treaties that have been concluded during different periods. As it can be seen, the majority of the treaties were signed during this era.

This phase can be characterized by modern logical pragmatism as far as economic policies are concerned.[31]

Total BITs concluded by IRI

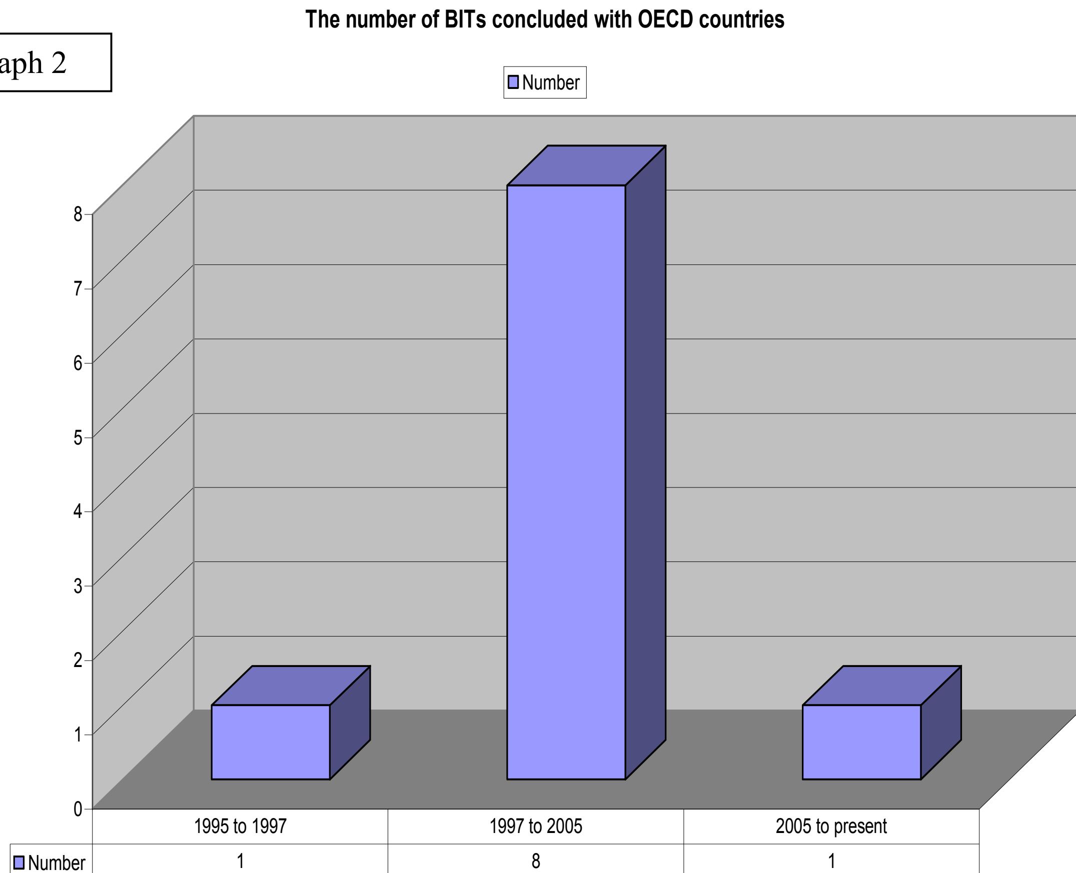
[30] See graph no 3.

[31] Nima Nasrollahi Shahri, "The Petroleum Legal Frame Work of Iran".



It was during the same era that the majority of the treaties with OECD countries were concluded. The number of bilateral investment treaties between Iran and the OECD countries during different eras can be seen in the chart

Graph 2



2-1-5. Current times:

The urge of the Iranian government to attract foreign investment survived President Khatami and the next governments followed suit. However, as can be seen in the graph number 3, the rate of FDI growth slowed and even became negative at a period. Besides, the conclusion of BITs also slackened off and there have been no more than three of them signed since 2005.

It should be noted that the policies of the Ahmadi Nejad administration, as far as foreign investment is concerned, have been, to a great extent, along the same lines as the previous administration. In fact, most of differences have had to do with the management of internal affairs of the country as well as foreign policy and there are not many economic policy differences.

However, dissatisfactory records of FDI during the last five years should probably be ascribed mainly to political tensions and partly the global recession rather than a legal change of mindset.

Many of the revolutionary ideologies and the xenophobia which existed after the revolution have been revived but it would be premature to decide whether the rise of Ahmadi Nejad justifies the creation of a new stage or not. This will depend on how far the administration policies will ultimately depart from the previous pragmatic governments.

What render the contemporary time quite complicated is the ever increasing unilateral sanctions which were mainly in response to the Iranian controversial nuclear issue. The sanctions admittedly have kept many foreign investors at bay and have reduced foreign investment at

least outside the energy sector to a trickle.[32] Even in the Iranian energy sector, current Iranian partners such as China and Russia are mainly willing to invest only in the profitable upstream oil projects. In addition to this, China does not have the top notch technological expertise to help Iran sustain the development of its oilfields.[33] Iran is in much need of foreign investment in its oil industry even to maintain the same level of oil production. Oil consumption in Iran is increasing sharply as the population grows and as the production has not increased in the last few years the amount of oil export is likely to drop; most Iranian oil fields are depleted and the cost of production is on the rise[34] and there has been very little investment for exploration of new fields. Considering the increasing domestic consumption of Iran, should this trend continue, Iran may even one day become a net importer of crude oil in some years. Iraq, the Iranian western neighbour, has started its ambitious programs to elevate its production to more than 10 million barrels per day in a few

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[32] Palash R. Ghosh "While Iran's President Assails Western capitalism, His Country Reels" International Business Times, 23 September 2010, http://www.ibtimes.com/articles/65146/20100923/iran-sanctions-economy-gdp-inflation.htm.

[33] ibid.

[34] Oil and gasoline are heavily subsidized in Iran. Therefore, not only does a rise in domestic consumption deprives the government of export revenue, but it also creates a heavy burden on the Iranian government for subsidization. However, there are plans to gradually remove energy subsidies which seem to be a response to high consumption and high unnecessary government expenditures.

years threatening the position of Iran among OPEC members. As for gas, the picture is by no means rosier. The Iranian production is almost as much as its domestic consumption; this, considering its possession of the second biggest gas reserves in the world, is downright disastrous. The gas industry is very capital intensive and finding a market is of crucial importance since gas storage is neither practically feasible nor economically viable. The Buyback contractual regime has not appealed to foreign investors[35] and the sanctions have accentuated foreign firms' unwillingness to make investments in the Iranian gas sector. The Iranian LNG program has also recently been abandoned not meeting with much enthusiasm on the part of foreign investors.

2-2. Investment in Iran (Figures and statistics)

What renders studying the Iranian investment records a demanding task is substantial differences between the statistics given by domestic and foreign sources. As well as that, the government is always trying to paint a rosy picture of the Iranian economy even if that involves modifying the statistics unfairly.[36] In an attempt to exaggerate the government's success

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[35] Shiravi, *A.*, Ebrahimi, N., 2006. "Exploration and Development of Iran's Oilfields Through Buyback", Natural Resource Forum30, (2006): 199.

[36] In Iran, there are no independent organs for collecting statistical data and there is governmental monopoly on statistics. As an example, the government has not announced the GDP growth for the last two years.

in attracting investment, in the year 2007 the data given to the media for FDI inflow to Iran was the amount of foreign investment approved by the government and not the actual investment made in the country. As a result, the amount of foreign investment announced by Iran in that year was over ten times more than the amount published in the UNCTAD world investment report[37].

In the year 1994 when Iran started attracting foreign investment there was merely no more than $ 284,000 of investment. This figure increased to more than a billion dollars in the year 2001 and reached the highest in the history of the country, over three billion and a half, in the year 2002. Until the year 2005, the figure did not grow but fluctuated between $270,000,000 to 3 billion dollars. Despite the increase in the price of oil and contrary to expectations investment in-flows dropped to hit its lowest point in the last eight years in the year 2007. The amount of foreign investment in the year 2009 was just under $275,000,000. It seems that the best records of foreign investment belong to the Economic reforms period (2001-2005) which does not come as a surprise considering the policies of the administration in power during those years.

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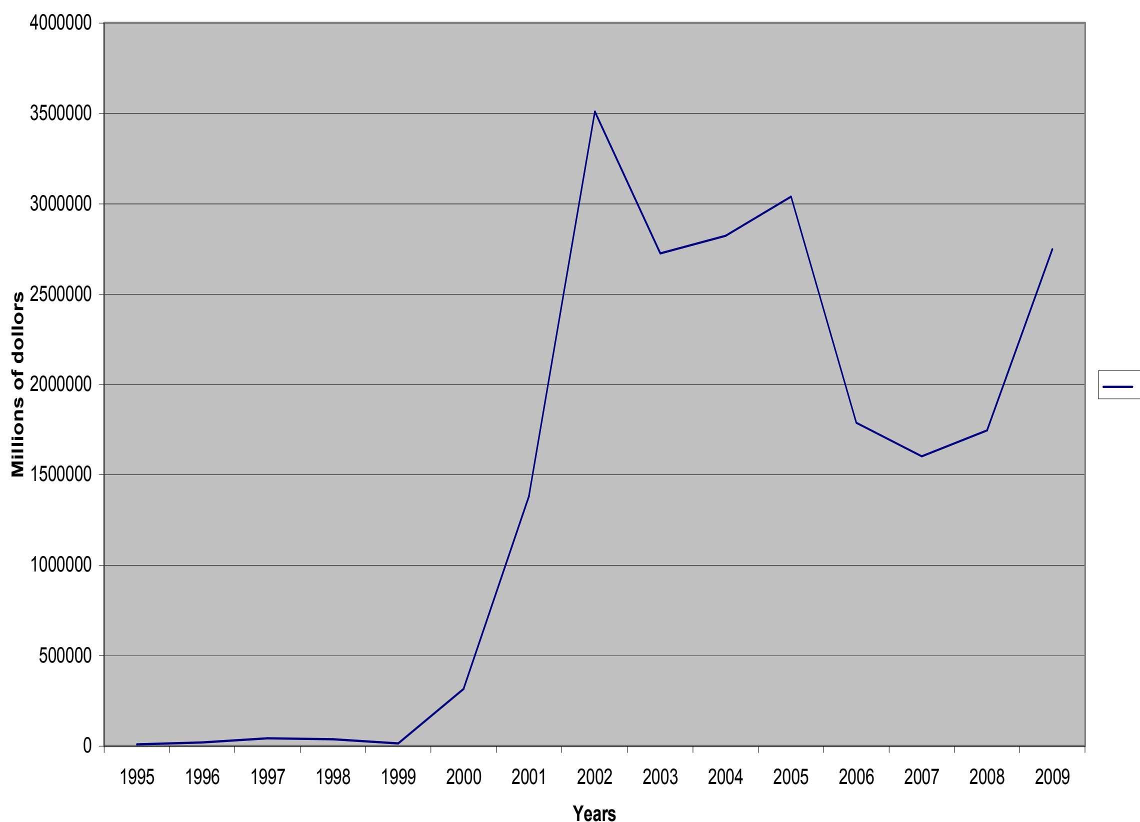
[37] "One Worthless Zero in Announcing the Amount of Foreign Investment"[in Persian], Tabnak news agency, (17 October 2007) http://www.tabnak.ir/fa/news/204/.

The figures discussed above can be more easily compared in the graph below which shows the total amount of FDI in-flows between the years 1995 to 2005. As can be seen in the graph, there is a marked difference between different time eras which is a reflection of how important the policies of each government could be in attracting foreign investment.

Graph 3

The FDI inflow to Iran from 1995 to 2009



Source: The figures come from the official website of the Organization for economic investment and technical assistance: http://www.investiniran.ir/

2-3. the domestic legal framework for foreign investment in Iran:

There have been several deliberate attempts to modify the Iranian domestic legal climate regarding foreign investment in the last ten years. Some of the major improvements in this area have been the amendments made to the Iranian Constitution to allow for private ownership of some mother industries in 2005[38], unification of the currency rate in the year 2002[39], and legislation of an Act regarding the protection of foreign investment in the year 2002.

The very first Iranian Law concerning and offering protection for foreign investments in Iran was an Act entitled "the law on Attraction and Promotion of Foreign Investment (in short usually referred to as LAPFI) which was ratified in 1955. After the revolution this law was practically no more applied since there was literally no foreign investment to be covered by it and the government had no specific policies to attract foreign investment for a few years to come. However, once foreign investment regained its significance in the Iranian economic policy in the second decade after the revolution, there was no option but to apply the law despite all its shortcomings, until finally The Foreign Investment Promotion and Protection Act (henceforth FIPPA) was legislated in the

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[38] General Policies of Article 44 of the Islamic Republic of Iran Constitution, Expediency (Exigency) Council May 22, 2005.

[39] Ebrahimm Abbasi, "Attraction of Foreign Investment in Iran"[in Persian], Hamshahri daily newspaper, http://www.topiranian.com/maghalat/archives/009827.html (accessed December 10, 2010)

Islamic Parliament and the Expediency Council[40] and its Implementation Regulations were approved in the year 2002.

The enactment of the FIPPA happened as a complement to a whole host of macro-economic reforms which had started in Iran since the middle of the 1990s. Some key elements of the reforms include:

1. Unification of foreign exchange rate and considerable liberalization of foreign exchange system;

2. Establishment of numerous private banks and other non-governmental private non-banking credit and financial institutions;

3. Legal reforms for the establishment of private insurance companies;

4. Removal of a broad range of non-tariff barriers and further liberalization of the foreign trade regime;

5. The inception of a new income tax regime which offers a single and competitive flat tax rate of 25%, and a variety of exemptions for manufacturing enterprises and total exemption for export-generated revenues;

6. Persistent stress on the transference of state-owned enterprises including public sector banks to the private sector.

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[40] The exigency council is the conciliatory organ that deals with bills that have been passed by the Parliament ,but are not ratified by the Gaurdian Council to become law on the ground that they are either contradictory to the Constitution or Islamic Sharia (It acts based on article 112 of the Iranian constitution).

2-3-1.FIPPA

The English translation of the Act is added to this study as an appendix and can be consulted duly.

As far as the form is concerned, FIPPA is organized in seven chapters and includes twenty five articles.

Based on this law, foreign investors, who are 'non-Iranian natural and judicial persons or Iranians using capital of a foreign origin'[41], need to obtain a license to import capital[42] to the country, which is an acceptably broad definition of foreign investors. Foreign capital could be imported to the country through cash funds , converted to Rials or used directly, or items in kind[43] which could include machinery, intellectual property, tools and spares[44] and the like which need to be evaluated upon admission by competent authorities.[45] The evaluation process is likely to vary depending on the type of proposed non-cash investment in question.[46] The authority for issuing the investment license is the Organization for investment, economic and technical assistance of Iran which admits investments for the purpose of development of producing,

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[41] FIPPA, Article 1.
[42] Ibid.
[43] FIPPA, Article 11.
[44] FIPPA, Article 1.
[45] FIPPA, Article 11, NOTE.
[46] A. Avanessian, Torossian, Avanessian & Associates, "foreign investment in Iran"[in Persian], www.bicc.org.uk/downloads/**Foreign**%20**Investment**%20in%20**Iran**.pdf.

mining, agriculture and services in the country[47]. Such investment is admitted if it 'brings about economic growth, upgrades technology enhances quality of products and increases employment opportunities and exports'[48] and, equally importantly, it should not be detrimental to the environment, pose threats to the national security, be damaging to the economy or disrupt local production and it should not include the grant of a concessions[49] to foreigners. There is an important limitation for admission of foreign investment in this law, often criticized as one of its weaknesses, which is the limited proportion of the value of goods and services produced by the foreign investments to the value of goods and services supplied to the local market. At the time when the investment license is issued, this ratio should not exceed 25% in each economic sector and 35% in each sub-sector.[50] This can be justified as supportive to local industries as a certain market share is attempted to be guaranteed for them. Another potentially discouraging factor is that the ownership of property by foreign investors is not allowed by this law.[51] Investment is

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[47] FIPPA, Article2.
[48] FIPPA, Article 2, part A.
[49] A concession has been defined as the right which places the foreign investor in a monopolistic position. There is a lot of sensitivity as to the word concession within the Iranian law which might have historical roots. It should be noted that granting concessions to foreigners is forbidden by the Iranian constitution (Art 81).
[50] A. Avanessian, Torossian, Avanessian & Associates. "Foreign Investment in Iran".
[51] The law for the ownership of immovable property by foreign nationals (1921) is still in force and there is nothing in FIPPA to render such ownership permissible.

admitted under two categories; foreign direct investment is admitted only in sectors where private ownership is permitted[52], whereas foreign investment is permissible through 'Civil partnership', 'Buyback' and 'Build-Operate-Transfer' schemes in all the sectors of the economy. Investment by foreign governments depends upon the approval of the Islamic parliament on a case by case basis.[53] Article 8 of the Act provides for national treatment since foreign investment is granted all rights, protections and facilities offered to local investments. This act, in comparison with the previous law, has discarded much of the complexities and is much more transparent as it has tried to expedite the necessary processes to the extent possible. It provides that each relevant organization should have a fully authorized agent in the organization for foreign investment, technical assistance. This does away with much of the burdensome bureaucracy which was previously a major cause of concern for foreign investors.

Based on the Act nationalization and expropriation can only take place if done on a non-discriminatory basis and for public interest by means of a legal process subject to the payment of appropriate compensation on the basis of the real value before expropriation. To seek remedy, there is a

[52] FIPPA, Article 3 part A.
[53] FIPPA, Article 4.

one year time limit to apply for compensation on the grounds of expropriation which should be submitted to the Board.[54] Foreign investors can transfer profits derived from their investment as well as the principal of their foreign capital and the balance of capital remaining in the country subject to the fulfilment of all their obligations and payment of all dues upon the approval of the board.[55] The foreign exchange needed for transfer of money can be secured using the Iranian banking system or out of foreign exchange earned from the export of products or the 'foreign exchange earned from service activities of the enterprise in which foreign capital is employed' and also through export of permissible goods. One or a combination of these methods can be applied, which needs to be specified in the investment license. This investment license counts as an export license if the method mentioned is through export of goods and services. The central bank should secure and make available foreign currency to the foreign investors upon the agreement of the organization and the confirmation of the minister of economic affairs and finance.

[54] The foreign investment board is established under article 6 which is the authority for investigation of admission applications.
[55] FIPPA, Articles 13 and 14.

The Act refers all disputes which are not resolved through negotiations to the Iranian domestic courts. However, in the case of the existence of a Bilateral Investment Treaty between Iran and the country to which the foreign investor is a national, the dispute settlement mechanism of the BIT will prevail.

Based on Article 20, all the relevant executive agencies should take measures for the issuance of entry visa, permit of work or residence for all the foreign investors, managers, experts as well as the private sector linked to foreign investment under the act upon the request of the organization.

2-3-2 Advantages of FIPPA over its predecessor:

The enactment of FIPPA has enhanced the investment legal regime of the country in several ways when compared to its predecessor, the LAPFI. Some of the main advantages are summarized here.

1. There are broader fields for investors to be involved in including the country's infrastructure compared with the previous law.

2. The definition offered for foreign investment is much broader and covers all kinds of investments including (FDI) as well as various kinds of project financing methods such as "Civil Participation", "Buy-Back"

arrangements, "Counter trade", and different types of "Build-Operate-Transfer" (BOT) schemes.

3. The Creation of the "Centre for Foreign Investment Services" at the (OIETAI) offers focused and highly efficient support for foreign investment undertakings in Iran.

4. Licensing application and approval procedure have been expedited;

5. There are more flexible and much simpler regulatory practices for the access of foreign investors to foreign exchange for capital transfer purposes envisaged in this law;

Chapter three: International treaties

3-1.Bilateral investment treaties

3-1-1.Definition and history:

Bilateral investment treaties are agreements negotiated and concluded between two countries according to which the 'investments made by the nationals of the two states parties in each other's territory will be protected'.[56] By and large, BITs aim to promote, facilitate and protect foreign investment.[57]

Bilateral investment treaties are a fairly modern phenomenon. However, their precursor, 'treaties of Friendship, Commerce and Navigation' took off initially in the nineteenth century. They were comparatively much more diverse and went beyond commerce even incorporating military provisions. However, there was no particular mention of foreign investment in the early FCN treaties until they became more investment specific[58] after the World War II. FCN treaties before the war, largely in

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[56] M. Sornaraja, The International Law on Foreign Investment, 205.
[57]Andrew T. Guzman, Alan O. Sykes(eds), Research Handbook in International Economic law, Edward Elgar Publishing Limited (2007, United Kingdom),214.
[58] Ibid, 216.

response to the circumstances then, did not offer any protection for corporate entities and were only applied to individuals[59].

After 1945, FCN treaties continued being concluded at more rapid pace[60] but, in many instances, under different names. Occasionally, the United States entered treaties called 'Convention of Establishment'. 'Agreements for the Promotion and Protection of Investment' was how the United Kingdom referred to its FCN treaties. When Switzerland was a party they were entitled 'Agreements for the reciprocal promotion and protection of investment'. The Soviet's 'Treaties of friendship and cooperation' despite their similarity of title to the American treaties were of a much less economic character and were chiefly political. [61]

The first BIT ever was negotiated between the war-stricken Germany and Pakistan in the year 1959. Initial BITs were concluded , to a large extent due to the increasing risks of expropriations done in the 1960s The preliminary growth rate of these treaties was nothing near remarkable, but they caught on before long and started growing exponentially especially during the last two decades of the twentieth century between countries of all levels of development. As time passed

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[59] ibid.209.
[60] ibid.210.
[61]Ocran, T. Modibo, "Bilateral Investment Protection Treaties: A Comparative Study", New York Law School Journal of International law & Comp. L. 8, (1986-1987).

there were increasingly more intra-developing countries' treaties as well as more intra-developed countries' treaties and they were no more exclusively drafted between the developing and the developed world. As of the year 2005, there was a network of roughly 2400 treaties in existence which grew more than 2800 before 2010.

BITs are different from many other treaties in that there is an inherent imbalance of power and an enormous difference between the bargaining positions of the two signatories. As a matter of fact, since they have been traditionally signed between capital importing and capital exporting countries[62] with huge technology and wealth disparities, contrary to their outer shell most BITs practically encourage only a one-way flow of investment, if any thing at all[63]. Developing countries undertake to guarantee protection for the capital that they may never even receive and this unilateral undertaking is not reciprocated i.e. there are no obligations on the part of the capital exporter to guarantee a minimum of investment out-flow to the other party. In other words, 'there is an erosion of

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[62] Jeswald Salacuse, "BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries", International Law24, (1990)655- 656.
'A BIT purports to create a symmetrical legal relationship between the two states, for it provides that either party may invest under the same conditions in the territory of the other. In reality, an asymmetry exists between the parties to the BITs since one state will be the source and the other the recipient of any investment flows between the two countries'.
[63] ibid

sovereignty by one party without corresponding erosion in the other party'.[64]

Surprisingly, BITs are effectively based on principles that developing countries have long historically objected to, such as prompt adequate and effective compensation for expropriation or the right of the foreign investor to recourse to international arbitration.[65] From a perspective, they are more of a symbolic gesture on the part of developing countries to signify their political and philosophical stance towards foreign investment.[66]

Another important matter of debate among international lawyers as to the role of these treaties is whether their unprecedented proliferation in recent years can give rise to customary international law or not. While it is widely held that their commonness means that they have become part of international customary law, it is deemed more realistic to hold that despite their identical external shell, due to the substantial differences in their content they can only constitute a type of lex specialis.

[64] M. Sornaraja, The International Law on Foreign Investment, 208.

[65] Kenneth J. Vandevelde, "The Economics of Bilateral Investment. Treaties", Harvard International Law journal 41 ,(2000): 469.

[66] Ibid.

3-1-2.Features of bilateral investment treaties:

There is a basic similarity to the structure of most BITs. Typically and like almost all other treaties one would begin with a prefatory statement stating the aims and objectives of the treaty which would normally be 'protection and encouragement of investment'. However, this will not give rise to a positive duty on the part of the capital exporting country to encourage a minimum of investment[67]. This is usually followed by definitions of the terms used within the treaty and the scope of its application. Some of the main features of a typical bilateral investment treaty are listed and explicated here.

3-1-3. Scope of application and definitions:

The scope of the treaty is usually delimited through the definitions offered in the treaty. As a general rule of thumb, there is a pronounced tendency in existing BITs to define investment as broadly as possible including tangible, intangible and intellectual property as well as company equities[68] to maximize protection. Investment is usually defined to comprise foreign direct investment and portfolio investment. However, many BITs limit their protection only to investments made in

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[67] ibid.

[68] Andrew T. Guzman, Alan O. Sykes(eds), Research Handbook in International Economic Law, Edward Elgar Publishing Limited(2007, United Kingdom)

complete accordance with local laws and sometimes certain admission procedures are required to be followed. As a matter of fact, the host state is usually allowed to prevent foreign investment from being established in the first place or admit it conditionally, yet after the foreign investment has been admitted the host state faces major constraints to regulate it [69]. Some treaties do not include tax provisions and therefore it is possible for the host state to tax the foreign company more heavily which is of course in violation of non-discriminatory behaviour in the vast majority of the treaties unless it has been reserved as an exception.[70] In other words, some treaties carve out taxation from the application of the treaty standards. This is because Bits are applicable to all regulatory measures unless otherwise stated.[71] There is also mixed practice as to whether the protection could be extended to investments made prior to the treaty or not. Another key part of the treaty has to do with the criteria based on which nationality has been defined. Nationality is just as important for natural persons as corporate bodies and its definition could affect the scope of application. However BITs tend to cover a wide

[69] Kenneth J. Vandevelde.
[70] ibid
[71]. William *W*. Park, *"* NAFTA Chapter 11 Arbitration and the Fisc*:* NAFTA's. Tax Veto", Chicago. Journal of International Law2*,* (2001).

breadth of legal entities as far as their type is concerned.[72] Recent BITs have tried to address the complexities which have arisen because of the rise of multi national companies by combining different traditional tests of nationality.

3-1-4. Standard of treatment: For two hundred years there had been sharp difference of opinion on whether aliens were entitled to a minimum treatment or not. Standards used before the widespread proliferation of BITs included a very wide spectrum ranging from the Calvo's famous doctrine of 'reverse national treatment' often advocated by developing countries to the Hull rule[73] put forth by Cordell Hull, the then US secretary of state, after the nationalization of many US citizens' properties following the Mexican Nationalization of 1932. BITs are now a hefty network of treaties that appear to have miraculously resolved this longstanding seemingly irresolvable conflict[74]. However, realistically talking, one would come to the conclusion that in this respect developed countries appear to have gotten their way. Here some of the traditionally

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[72] Andrew T. Guzman, Alan O. Sykes(eds), Research Handbook in International Economic Law, Edward Elgar Publishing Limited(2007, United Kingdom)

[73] 'Hull rule… requires full compensation, in the event of expropriation of the property of the foreign investor, to be prompt, adequate and effective and favours the doctrine of subjecting the regulation of foreign investments to international law' see Babatunde Lot Ogungbamila , "BITs Are they shields or swords in the hands of foreign investors", CEMLP Annual Review (CAR), 2007/2008.

[74] Judge Stephen M. Schwebel, "The Overwhelming Merits of Bilateral Investment Treaties", Suffolk Trans national Law Review32, (2008-2009): 265.

common standards of treatment including those usually applied in modern BITs are presented.

National treatment: Based on this standard the nationals to the treaty party should not be accorded a treatment less favourable than that accorded to the nationals of the host country. This, however, has not been very appealing to foreign investors since there have been established historical precedents of gross misuse from this standard.[75] A common feature of FCN treaties especially when combined with most-favoured nation treatment, it has now given its place to higher and more investment friendly treatments in BITs. Unlike the past that this standard was constantly rejected by capital-exporting countries, today many countries reserve several economic privileges for their nationals. Therefore, this standard can become tantamount to non-discrimination and has therefore gained relevance for developed countries[76]. Countries that impose performance requirements would normally exempt performance or entry requirements from this standard of treatment.

Fair and equitable treatment:

Unlike national treatment it is an absolute standard in the sense that it should be accorded to aliens regardless of the treatment the citizens of a

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[75] Examples can be incidents which ensued the Mexican nationalization and the Russian revolution.
[76] Sornaraja, M., The international law on foreign investment,215.

country receive. However, it is vague and its vagueness has, so far, prompted tension and conflict[77]. This standard found its way into investment law literature from the Havana charter in 1948.[78] Based on its article11 (2) foreign investment had to be assured 'just and equitable treatment'. It was through this channel that this standard started being adopted in many FCN treaties as well as the Energy Charter treaty and NAFTA.[79] In some BITs this standard has been prescribed with no strings attached while in many it has been mixed with other standards or in reference to international law[80]. 'the international standard is nothing else but a set of rules, correlated to each other and deriving from one particular norm of general international law, namely that the treatment of an alien is regulated by the law of nations' Undeniably, there is a big deal of overlap between this standard and Fair and equitable treatment[81] and drawing a clear line between the two has been a tough task for international tribunals. However, according to a NAFTA commission

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[77] UNCTAD, "Fair and Equitable Treatment" (1999). http://www.**unctad**.org/en/docs/psiteiitd11v3.en.pdf.

[78] OECD Working Papers on International Investment: "Fair and Equitable Treatment Standard in International Investment Law" http://www.oecd.org/dataoecd/22/53/33776498.pdf (accessed December 9, 2010).

[79] Olatokunbo Lad-Ojomo, "What is The Difference between Fair and Equitable Treatment Standard and the Minimum Standard of Treatment under Customary International Law", CEPMLP Annual Review (CAR) 2008/2009.

[80] ibid.

[81] ibid

interpretative note, the fair and equitable standard is noting additional to the international minimum standard of customary international law.[82]

Most-favoured nation treatment:

Having its roots in FCN treaties, MFN has become an important and defining part of all BITs. This, given the abundance of these treaties, translates to the accordance of the highest standard ever accorded in any BIT to all investors regardless of what country they come from which might sometimes bring about unwanted results. There has already been a precedent for MFN regarding dispute settlement mechanism; it was held that a foreign investor protected by a bilateral treaty could use the more appealing terms of another treaty.[83] However, states belonging to regional organizations or multilateral treaties containing more favourable terms would normally seek to exclude them from the purview of their BITs to prevent their unwanted extension through MFN provisions.

3-1-5.Admission and Performance requirements:

Under customary international law, countries are allowed to admit foreign investment as well as aliens or not. In most treaties the same approach is adopted and rarely have any treaties conferred an absolute

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[82] Sornaraja, M., The International Law on Foreign Investment, 233.

[83] *Maffezini* v. *Spain* (2000) 5 ICSID Rpts 396.

right to admit all foreign investments.[84] In most other treaties, admission of foreign capital has been made subject to the laws and regulations of the host country.

In addition to this, in order to maximize the benefits of investment, host states try to impose some obligations on the foreign investor including the obligation to export part of the production, buy local goods and use local labour. The obligation to export part of the product is an attempt to protect local entrepreneurs who may not have the financial strength to compete with big multinational companies having a much lower cost of production. Using local goods and labour could also each in a way benefit the economy of the host state. However, developed countries are not exactly appealed by the idea and there have been attempts to prohibit them. The Trade Related Investment Measures (TRIMS)[85] is to an extent based on the prohibition of performance requirements. Some countries such as the United States and Canada have completely excluded them from their BITs.[86] Despite their apparent merits for the host country, they seem to be against the national treatment and non-discrimination requirements entrenched in most treaties; it is possible, however, to

[84] Liberalization of investment treaties has been undertaken by US and Canada. See, for example, the agreement between Canada and El-Salvador (1999) for promotion and protection of investment.
[85]Sornaraja, M., The International Law on Foreign Investment,238.
[86]Sornaraja, M., The International Law on Foreign Investment,238.

exempt performance requirements from non-discrimination requirements of BITs.

3-1-6.Repatriation of profits:

One of the main objectives of investments treaties is the protection of the right of the investor to repatriate its profits[87]. Logically without being able to do so, there would be no incentive for investors to make foreign investments. However, not all the treaties grant an absolute right of repatriation to foreign investors; difficulties usually arise at times of economic crisis and an absolute right of repatriation in such situations is very cumbersome. In many UK treaties, as an example, there is an undertaking to repatriate a maximum of 20 percent of the profit in difficult economic conditions.

3-1-7.Dispute resolution mechanism:

Most states are not normally akin to the idea of international arbitration for their state contracts, including investment agreements, with foreign individuals. However, a foreign investor could use the bilateral investment treaty between its country and the host state, or another BIT with a third country by virtue of the MFN treatment, to seek remedy in

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[87] Sornaraja, M., The International Law on Foreign Investment,238.

international arbitration. Almost all BITs have provisions regarding international arbitration. Two different dispute resolution mechanisms are normally stated in BITs. One concerning the possible disputes between the foreign investor and the host state which are typically provided to be resolved under an international arbitration institution such as the ICSID or ICC or, otherwise, on an ad hoc basis. This, by itself, can prevent disputes between investors and host states from respectively becoming a dispute between the two states.[88] The second type involves disputes between the two host states which are also normally resolved through arbitration with the difference that in case of a failure to choose the arbitrator on the part of one country, more often than not, the head of the International Court of Justice is put in charge of choosing the arbitrator. This has been one of the major legal developments brought about by the emergence of investment treaties; many developing countries had long rejected the jurisdiction of arbitration tribunals over investment contracts. It should be noted, however, that because of the

[88] I. Shihata, "Towards a Depoliticisation of Foreign Investment Disputes: The Roles of ICSID and MIGA", ICSID Review 1 (1986):1.

diverse nature of dispute settlement provisions of different BITs no uniform patterns have emerged.[89]

3-1-8. Bilateral Investment Treaties of the Islamic Republic of Iran

Despite their global widespread commonness especially during the 1980s and 1990s, bilateral investment treaties are a rather new concept to the Islamic Republic of Iran. However, Iran had entered into a number of FCN treaties including one with the USA in 1958, which formed the basis of jurisdiction of the ICJ in the Hostages[90], and Oil Platform[91] cases.

The reason why there was a disinclination to sign investment treaties with other countries might have been that there had not been any investment specific domestic regulatory framework in the country since the 1979 revolution which ensued massive nationalization of all industries by the government and the prohibition of foreign investment by the Iranian constitution. The very first BIT Iran concluded was with Armenia in the year 1995. Interestingly, the first instances of these treaties were all negotiated with economically mediocre neighbouring

[89] Antonio Parra and Ibrahim Shihata, "Provisions on the Settlement of Investment Disputes in Modern Investment Laws, Bilateral Investment Treaties and Multilateral Treaties on Investment", ICSID Review 12, (1997): 287.

[90] *Hostages* case. 119 *ICJ* Rep., 1979,

[91] Oil Platforms (Islamic Republic of Iran v. United States of America) 2003.

countries which had never been particularly capital exporting at least to Iran. In fact, Iran did not conclude any treaties with developed countries for the first some years until 1998 when the Iran-Switzerland bilateral investment treaty was concluded. Despite the fact that the country began considering foreign investment as a supply for its development program after the war during the reconstruction period, it was not until the early years of the first decade of the 20th century that such instruments became a key part of the country's economic policy largely as a result of the sweeping economic reforms that had commenced during the presidency of Mohammad Khatami as well as the international mood in favour of such treaties. There are forty six treaties in force at present. However, it is essential to note that only a very small fraction of these treaties have been concluded with truly capital exporting countries such as the OECD countries and others seem to be only political gestures and a step towards reinforcing political ties.

Like any other international treaty the Islamic Republic concludes, Iranian BITs need to be ratified by the Iranian Islamic parliament[92] as well as the Guardian council[93]. Once ratified, they become part of the

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[92] . Iranian Constitution, article 77.

[93] The guardian council is the authority to decide whether parliamentary legislations are in complete conformity with Islamic principles and The Iranian constitution.

domestic law and gain legal status and, in turn, concluding such treaties contribute to the creation of a safer legal framework conducive towards attracting foreign investment. A good reflection of the bargaining position and negotiating powers of the two parties in bilateral treaties, Iranian BITs are not uniform but share basic similar principles. Here, different provisions of BITs signed by Iran will be studied more closely with due references made. The English version of the BIT which was signed with South Africa has been appended to this study. Iranian BITs typically include 14 or 15 articles and follow a common pattern. However, many of the treaties have additional protocols suited to the agreement between the particular contracting parties.

(Total BITs concluded between Iran and other countries)

No	Country	Time of conclusion	Date of entry inoto force
1	**Armenia**	May1995	26 February 1997
2	**Belarus**	Jul1995	23 June 2000
3	**Tajikistan**	Jul1995	3 November 2004
4	**Georgia**	Sep1995	22 June 2005
5	**Pakistan**	Nov1995	27 June 1998
6	**Kazakhstan**	Jan1996	3 April 1999
7	**Turkmenistan**	Jan1996	29Apr2004
8	**Yemen**	Feb1996	16 October 2004
9	**Ukraine**	May1996	5 July 2003
10	**Kyrgyzstan**	Jul1996	27 June 2005
11	**Bosnia & Herzegovina**	Jul1996	25 August 2002
12	**Azerbaijan**	Oct1996	20 June 2002
13	**Turkey**	Dec1996	13 April 2005

14	**South Africa**	Nov1997	5 March 2002
15	**Lebanon**	Oct1997	14 May 2000
16	**Syria**	Feb1998	16 November2005
17	**Switzerland**	March1998	1 November 2001
18	**Poland**	Oct1998	26 October 2001
19	**South Korea**	Oct1998	**31 March 2006**
20	**Bulgaria**	Nov1998	**24 August 2003**
21	**Italy**	Mar1999	**27 July 2005**
22	**Qatar**	May1999	**5 November 2001**
23	**Sudan**	Sep1999	**19 October 2001**
24	**Croatia**	May2000	**2 August 2003**
25	**Uzbekistan**	Jun2000	**11 July 2004**
26	**Macedonia**	Jul2000	**19 August 2005**
27	**China, People's Republic**	Jul2000	**1 July 2005**
28	**Morocco**	Jan2001	**31 March 2003**
29	**Austria**	Feb2001	**11 July 2004**
30	**Tunisia**	Apr2001	**27 February 2003**
31	**Bangladesh**	Apr2001	**5 December 2002**
32	**Oman**	Dec2001	**8 April 2003**
33	**Romania**	Jan2002	**12 January 2005**
34	**Malaysia**	Jul2002	**4 August 2006**
35	**Germany**	Aug2002	**23 June 2005**
36	**North Korea**	Sep2002	**24 April 2005**
37	**Bahrain**	Oct2002	**12 October 2004**
38	**Spain**	Oct2002	**27 April 2004**
39	**Finland**	Nov2002	**25 June 2004**
40	**France**	May2003	**12 November 2004**
41	**Algeria**	Oct2003	**5 December 2005**
42	**Serbia & Montenegro**	Dec2003	**7 July 2006**
43	**Venezuela**	Mar2005	**7 June 2006**
44	**Sweden**	Sep2005	**2 March 2008**
45	**Afghanistan**	May2006	**2 February 2008**

The preamble and definitions:

The preambles of most treaties are almost identical except for minor differences in the wordings. The benefits of foreign investment as well as the countries' aim to strengthen their economic ties are usually stressed in the preamble.[94] The word investment is defined rather broadly in most Iranian BITs to include all the assets and property invested by one country according to the rules and regulations of the host country. These assets could be in the form of movable and immovable property, money and receivables as well as intangible property including intellectual property, company shares and patent rights and the right to search for and explore natural resources. The investor could be natural or juridical persons with the nationality of the contracting parties.

Standard of treatment and compensation of losses: Despite the bare minimum being similar, Iran seems to have taken a flexible stance. Standard of treatment and nationalization provisions of the treaties with developing countries are not elaborate and tend to be fairly brief, while in treaties with developed countries such as Sweden, there are more

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[94] As an example in the Iran- South Africa BIT it is mentioned: **"**Desiring to intensify the economic cooperation to the mutual benefit of both States;
Intending to utilize their economic resources and potential facilities in the area of
investments as well as to create and maintain favourable conditions for investments of the investors of the Contracting Parties in each others' territory and;
Recognizing the need to promote and protect investments of the investors of the
Contracting Parties in each others' territory;
Have Agreed as follows:" Most other treaties have very similar prefatory statements and there are no explicit differences between the first Iranian BIT with Armenia and very recent ones.

detailed terms and discussions. Based on all the treaties one party shall not nationalize, expropriate or confiscate the investment of foreign investors unless these measures are taken with due process of law in a non discriminatory manner and upon prompt, effective and immediate payment of compensation which amounts to the full value of the investment right before nationalization. In the Iran- Sweden BIT, there are more elaborate provisions as to the compensation paid. In particular, the compensation should be made public immediately after imminent nationalization or actual nationalization; the amount of compensation should be decided by the host state courts and should be paid in a freely transferable currency. If the payment of compensation shall be subject to delay compensation should include losses incurred because of delay as well. While in most treaties, as to the losses inflicted as a result of armed conflicts, riots and revolutions, the treatment offered should not be less favourable than the one accorded to any third party, in some treaties[95] with developed countries, certain exceptions have been numerated. For example, if such losses are caused by confiscation or destruction of property by the military of the host country, full compensation should be paid.

[95] Examples are BITs with Sweden and Finland and South Africa.

Entry and performance requirements: According to the overwhelming majority of BITs signed between Iran and other countries, contracting parties should accept all foreign investment coming from the contracting party. However, admission of investments is subject to the laws and regulations of each contracting party. Each contracting party is legally obliged to issue all the necessary licenses once the investment is successfully admitted. There are examples of treaties which take a more conservative position and do not admit an explicit undertaking to admit foreign investment at all[96] or mention that investment will be admitted once a number of condition are met[97]. However, since the majority of Iranian treaties do not contain such terms, it seems that these additional requirements should have been part of the BIT model of the other party. As to the entry requirements in the case of Iran, as discussed earlier, the FIPPA determines the limitations of investment and it is possible based on this law to decide whether a certain investment plan qualifies as legible or not based on a set of criteria. In some treaties the Organization for foreign investment, economic and technical assistance is introduced as the authority whose consent is essential for admission of foreign

[96] .Examples are: BITs with Armenia, Republic of Macedonia, Yemen, Kuwait.
[97] Examples are: BITs with Sweden, Indonasia.

investment[98]. However, even if this is not mentioned, the Iranian domestic laws, namely the FIPPA, provide for the investment license to be issued by the mentioned organization.[99]

Dispute settlement mechanism: As is the norm with all bilateral investment treaties, all disputes including those between the contracting parties and those between the host state and foreign investors are referred to arbitration. As far as disputes between the contracting parties are concerned, there is a more or less similar stance; the countries try to resolve the dispute amicably. In case of disagreement, the case will be decided by a panel of two arbitrators chosen by the two states and an umpire chosen by the arbitrators. If either of the contracting parties fails to choose an arbitrator or the arbitrators cannot agree upon an umpire, either party can request the head of the International Court of Justice to make the choice.

However, should there be a dispute between the investor and the host country, the position adopted in treaties between developing and developed countries is quite dissimilar; in treaties with developing countries, arbitration is provided as a choice over national courts, whereas in many other treaties especially those with developed countries

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[98] An example is the BIT between Iran and Zimbabwe, Bahrain.
[99] Article 5, FIPPA.

arbitration is the only option if negotiations and other alternative dispute mechanisms fail to resolve the conflict. In addition to this, developing countries seem to have an inclination towards the UNCITRAL arbitration codes. On the other hand, developed countries tend to prefer arbitration done under the auspices of institutions such as the ICC and ICSID.

Final provisions: In this part, as is the norm with most international treaties, entry into force terms, duration and authentic languages of the treaty are determined. Treaties involving Iran usually provide for Persian, English and the language of the contracting party as authentic languages; should any dispute arise as to the interpretation of the treaty, the English version would normally prevail. Many of the treaties remain valid for a period of 10 or 15 years. However, after the lapse of this period it will remain in force unless one of the contracting parties notifies the other of its unwillingness to continue with it with a six months prior notice.

3-1-9. Effectiveness of bilateral investment treaties:

In recent years BITS have become the main 'International legal mechanism for the encouragement and governance' of FDI.[100]

It can be argued that the standard of treatment provisions, mainly fair and equitable treatment, in a network of more than 2800 treaties has become part of international customary law and as part of international customary law it shall be binding upon all countries even those who have not signed any. This has emerged as a significant pleasing change in an area of international law which had been among the least definite and the most argued. Another important feature particularly benefiting nationals of capital-exporting countries is the dispute settlement provisions of most BITs. There is no doubt that the developed world have benefited hugely from the advent and massive proliferation of these treaties since, as capital exporters, their residents who aim to invest abroad have a much larger security margin and many previously disputed principles such as the right to access fair and impartial arbitration have become quite established thanks to investment treaties. The question which has been addressed numerous times, but remains to be answered definitively

[100] . Elkins, Z., Guzman, A., & Simmons, B. (2004). "Competing for Capital: The Diffusion of Bilateral Investment Treaties", Working paper. University of Illinois, University of California at Berkeley and Harvard University. 1960–2000.

is about the benefits they can potentially bring about as far as the developing countries seeking economic growth are concerned. In other words, do they fulfil their much sought after goal of increasing FDI flow to developing countries?

Some studies find no link between the two and consider the economic and political climate far more important than the legal structure.[101] There are many examples of countries with large FDI inflows without having developed a large network of BITs.[102] Empirical studies are much divided on the effects of BITs on the increase of FDI inflows for developing countries. (Eric Niumayer and Laura Spess 2005) finds a 'positive effect of BITs on FDI inflows that is consistent and robust across various model specifications'. While there are other studies (Hallward-Driemeier 2003) that suggest there is no significant correlation and others implying (Tobin& Rose-Ackerman 2005) a positive effect exists only for low-risk countries which are in fact those which need bilateral investment treaties the least. The increase in the number of BITs concluded can, by itself, be proof of their acceptance

[101] M. Sornarajah, State Responsibility and Bilateral Investment Treaties. Journal of World Trade Law, 20,(1986) 79–98.

[102] UNCTAD (1998). Bilateral investment treaties in the mid-1990s. New York and Geneva: United Nations.

among developing countries as an effective way of attracting foreign investment inflows.

Iran has also experienced a major, however, insufficient growth since she started concluding BITs. This increase can not easily be ascribed to its bilateral investment treaties alone. Most importantly because, as will be discussed in more depth in next chapter, before the year 1993 foreign investment had no place in neither the Iranian government's economic equations nor its legal structure. As well as this, the amount of investment Iran attracts is arguably far less than a country of its size and resources while the number of its BITs is quite typical. Therefore, it should be concluded that there are other factors preventing Iran from maximizing its foreign investment. The nature of these factors will be further clarified in next chapters of this study.

3-2.Double tax treaties

3-2-1.The issue of double taxation

Originally, taxation was an essentially domestic concept free from all international complexities, as taxes were imposed on immovable property by a sovereign power in whose jurisdiction the land was placed. However, the basis for taxation has undergone a transformation and has

been shifted to individuals, which may give rise to issues such as tax evasion and double taxation.[103] Double taxation arises when the same income is being taxed twice, which could normally happen if a tax paying-entity resident of a country does business in another country, usually referred to as the source country; since each country has its own sovereign right to tax income and its own set of tax rules, the taxpaying entity might be subject to taxes on the same income twice.

Taxation and fiscal transparency are important considerations for investors when drawing up an investment plan and opting for a destination. Clearly, 'Double taxation invariably increases the burden of tax on foreign income. This has a negative impact on cross-border movements of investment, technology and expertise.'[104] Some developed countries provide for relief against double taxation in their domestic income tax laws. Besides, to avoid this problem and to encourage international investment flows, countries have signed a quite big network of double taxation agreements (DTA).

[103] Oscar, M. Trelles I., "Double taxation/Fiscal Evasion and International Tax Treaties", Indiana Law review 12, no 2(1979): 341.
[104] "Agreements on the avoidance of Double taxation: Understanding our DTAs" http://www.iras.gov.sg/pv_obj_cache/pv_obj_id_867D105BE54EAB1A9ECF94767EB3CF588DFB0000/filename/dtawriteupforwebsiteamended.pdf.

3-2-2. the definition and a history of double taxation agreements

Double taxation agreements are usually bilateral treaties concluded between countries to avoid tax-related problems such as double taxation and, in some cases, tax evasion and to ultimately facilitate the flow of international investment. What a double taxation treaty does is provide clarity and certainty as to how and when taxes are imposed. These agreements endeavour to offer protection to investors against double taxation. As well as that, they aim to prevent discrimination between taxpayers on a global basis and try to provide an acceptable level of fiscal and legal certainty as far as taxes are concerned.

In fact, in a DTA, the taxing rights of each country are usually defined and often one or both countries are required to offer tax exemption or credit to obviate the problem of double taxation. In general, there are conceivably three possible methods for the allocation of tax incomes between the two countries:

“1. Full rights to tax only in one country, i.e., the other country exempts the income. The full rights may be allocated either to the country of source or residence.

2. Full rights to tax by both countries but with tax in the source country limited to no more than a specified level and the country of residence

giving a credit for tax paid in the source country. This form of allocation normally results in a sharing of tax between the two countries;

3. Full rights to tax by both countries without limitation and the country of residence giving a credit for tax paid in the source country."[105]

Although tax relief treaties can be traced to as early as the late nineteenth century[106]; they were mostly concluded between developed countries in the first half of the twentieth century. DTAs only emerged in the 1960s as an important feature of international fiscal policy of countries and did not gain any significant popularity until 1965, mainly because they did not appeal to developing countries. However, they grew commoner as time passed; the proliferation of DTTs resembles the spread and diffusion of BITs around the world (Fitzgerald 2002). Many such agreements provided that the source country forgo tax revenues by offering an exemption and as developing countries had little or no capital outflows, this mechanism worked against their interests and was conceived as unfair. This triggered international efforts to rectify their

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[105]. "Agreements for the Avoidance of Double Taxation: Understanding our DTAs"

[106] As an example there were actual tax agreements in force between Austria and Hungary in the late nineteenth century as well as agreements between Austria-Greece and Switzerland-Italy respectively in 1902 and 1904.
See more: *Adrian A. Kragen,* "Double Income Taxation Treaties:The O.E.C.D. Draft", California Law Review52 (1964) :306.

format and make them more favourable to tax-importing developing countries mainly in the 1960s.

Model treaties have been drafted internationally so as to facilitate and expedite conclusion of these treaties. There are two main models for tax treaties namely, the OECD model and the United Nations model treaty. It was acknowledged by the Fiscal Committee of the Organisation for Economic Co-operation and Development in 1965 that the treaties which had been in use until then did not take the circumstances of developing countries into account and were, therefore, of little interest to developing countries. The OECD model treaty was drafted in this context and aimed to tackle this problem. However, quite ironically, having been drafted by an organization composed of developed countries, the OECD model is alleged to favour resident based taxation which would be more beneficial to capital exporting countries, mainly developed countries. In fact, the UN model followed as an initiative taken by developing countries to balance the allegedly biased OECD model.

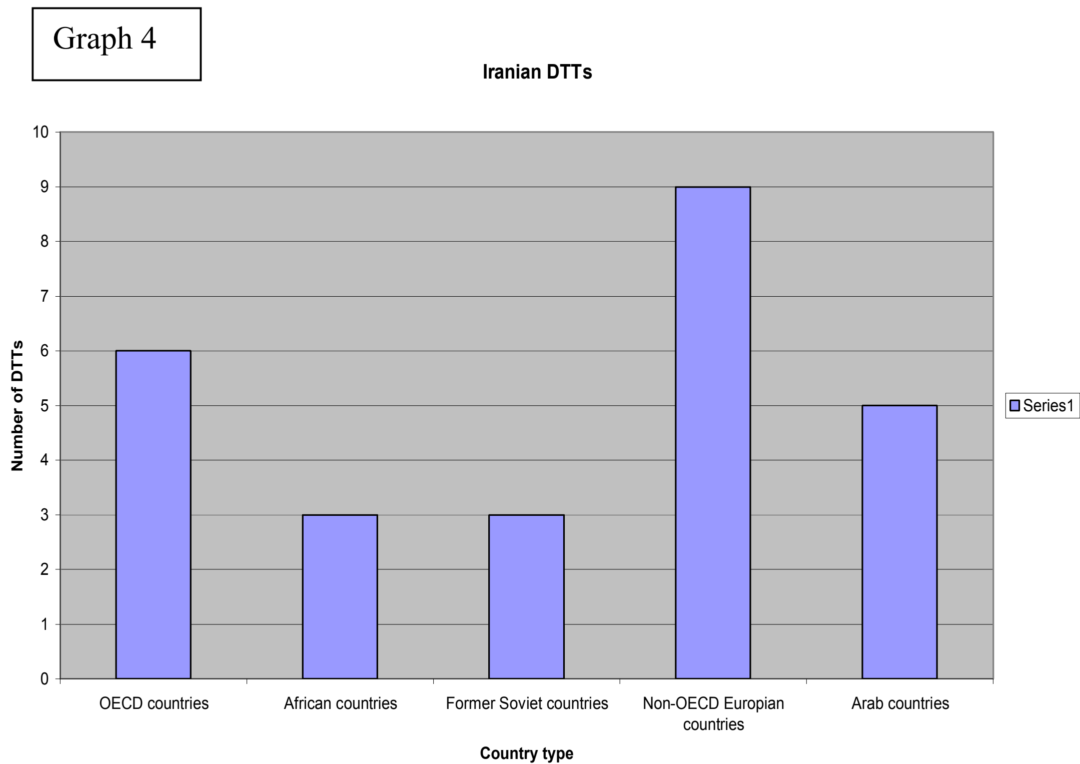
There are a number of OECD model treaties with the first drafted in 1968. However, The OECD model treaty which underwent major revision in 1997 is composed of 27 articles organized in seven chapters. The UN model, which was first drafted in 1980 and later revised in 1999,

includes 29 articles .There is striking similarity between the structures of the two model treaties as if the UN model has used the OECD pattern; it has been argued that the UN version is still biased against developing countries (Figueroa 1992). More importantly, it should be admitted that, still an overwhelming majority of DTTs use the OECD model (Arnold, Sasseville and Zolt 2002).

As to the DTTs concluded by Iran, the UN model has been adopted. The conclusion of these treaties was expedited in Iran throughout the economic reform period after 1996. As of March 2009, Iran had signed a total of 34 treaties. However, similar to what was stated about BITs, most treaty partners of Iran happen to be developing countries with insignificant capital exports.

The Iranian tax treaties become part of the domestic tax regime after parliamentary ratification like all other international treaties and are given the status of law.[107]

[107] Based on the Iranian Civil Law code, article 9, all treaties are given legal status upon ratification in the Islamic Parliament and the Guardian Council.



The list of Double taxation treaties signed by Iran

Armenia	Austria	Bahrain
Belarus	Bosnia & Herzegovina	Bulgaria
China	Croatia	France
Georgia	Germany	Indonesia
Jordon	Kazakhstan	Kyrgyzstan
Lebanon	Malaysia	Pakistan
Poland	Qatar	Romania
Russia	South Africa	Spain
Sri Lanka	Switzerland	Syria
Tajikistan	Tunis	Turkey
Turkmenistan	Ukraine	Uzbekistan
Venezuela		

Source: http://www.worldwide-tax.com

3-2-3. Effectiveness

Developing countries allocate resources to negotiating these treaties. As well as this, since most agreements typically favour residence based taxation rather than source based taxation, they will inevitably lose tax revenues[108]. This loss can only be justified if there is an actual increase in the FDI they have attracted as a result of these treaties.

Clearly, double taxation does not represent the most important reason barring foreign investment in a developing country [109] and the impediments go far beyond taxation, but avoidance of double taxation could be conducive to the creation of an investment friendly climate in any given country.

Like BITs, DTTs could be a friendly inviting gesture bringing about "international economic recognition" as a safe investment setting and goes much beyond the mere issue of taxation (Dagan 1999).

There are a number of studies that have tried to investigate the possible links between investment inflows and the conclusion of DTAs. Some other studies generally group them with BITs and study the effectiveness

[108] Eric, Neumayer "Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?" Journal of Development Studies 43 ,8 (2007): 150.

[109] ibid.

of international treaties in general[110] on investment. (Simmons 2006) finds a very strong positive correlation between the FDI flow and national tax system attributes. In fact, the tax regime of a country is an important factor involved in the amount of investment a country can attract. Simons has taken the 'availability and extent of relief for double taxation' into account as one of the attributes of corporate taxing systems in his study. Considering this matter and given that DTAs serve to modify the tax regime of countries, even though insignificantly, it appears logical to extend his findings to DTAS. Eric Neumayer(2007) finds that signing a DTT with the USA or a higher number of DTTs will promote Foreign investment inflows. However, this is found to apply only to middle-class developing countries and not low-class developing countries.

It seems that the link between concluding tax treaties and attraction of foreign investment is more than tenuous. This, however, does not justify the huge costs developing countries have to bear to enter such treaties, or at least all of them; countries should be more calculating when choosing

[110] K.P. Sauvant, L.E. Sachs (Eds.) "The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows", Oxford University Press, Oxford/New York (2009).

treaty partners. In particular, a higher number of treaties with wealthy eveloped countries should be more desirable.

Chapter four: Impediments to foreign investment

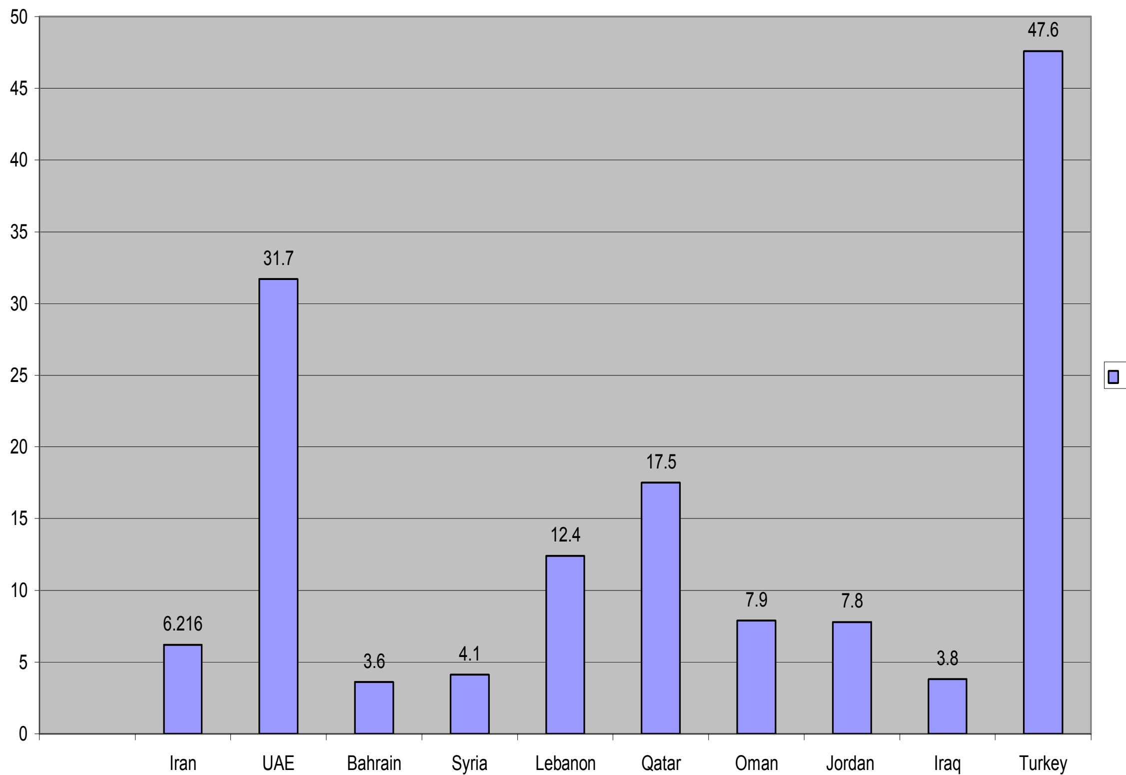
As it was discussed in previous chapters, the Iranian government has become much more aware of the benefits of foreign investment on its economy in the last twenty years; Iran has tried to modify its economic and legal climate so as to make it more favourable to foreign investors primarily through legislation of an investment law. As well as this, it has concluded a relatively big number of international treaties as a friendly inviting gesture to foreign investors. Despite all its efforts, admittedly, Iran has not been successful in absorbing sufficient foreign capital especially considering its needs and compared to international standards for a country of its size, population and resources; the total amount of FDI approved by the government between the years 1993 to 2008 was approximately 34 billion dollars of which only about 10 per cent has actually entered the country. This considering the 100 billion dollar need for foreign investment, often cited by Iranian authorities, is less than

satisfactory.[111] It appears that there must exist further barriers which have not yet been duly addressed. As it can be seen in the chart below, Iran has not attracted much foreign investment compared to its neighbours while most of them do not have any competitive advantage over it. In fact, among the countries listed, Iran has the largest natural resources, is the largest of all and has a huge market size compared to others. Considering all these privileges, it takes a country terribly poor investment attraction policies to be this unsuccessful in attracting foreign investment.

[111] Ali Mjedi, "Impediments to Foreign Investment"[in Persian] ,Iran Economist website, http://www.iraneconomist.com/economic/economic-articles/2901-2009-04-20-06-22-24.html.

Total FDI inflow to some Middle Eastern countries between 2007 to 2010 (UNCTAD)

Graph 5



It can be seen in the chart that Turkey, UAE and Qatar have had the best records regionally. Putting Turkey aside, having admitted less foreign investment than Qatar and UAE, which are very insignificant in size and do not have any real economic advantages over Iran, speaks for itself. If this fact is put in the context of the Iranian mammoth oil reserves, the need for further studies into the causes of the possible reasons for the failure of the government to attract FDI seem very obvious.

The Islamic Parliament research centre mentions three main impediments to foreign investment in Iran. 1. Cultural reasons; 2. The non-competitive and non-liberal nature of the Iranian economy compounded by an abundance of non-transparent laws; 3. High economic risks in Iran.[112]

(Affifi 2005), however, believes that the main barriers to investment in Iran are less economic in nature and are mainly political and legal including primarily the ever increasing tensions between Iran and the west, United states and Israel especially, recently, as a result of the Iranian nuclear program, a xenophobic attitude towards foreigners in Iran, a lack of legal transparency, difficult legal procedures and bureaucracy[113]. In this study, impediments to foreign investment in Iran have been listed and discussed under four very broad categories, namely cultural impediments, political impediments, economic impediments and legal impediments.

4-1.Cultural and religious impediments: The first instances of foreign investment in Iran, namely the Reuters and Darcy concessions, however

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[112]"The Most Important Impediments to Foreign Investment were Investigated"[in Persian] , No 6011, Resalat Newspaper, Page 16 Economic Page, 15 November 2006.
Based on the same report, the rate of investment risk in Iran is 59 percent which compares unfavourably to Singapore 11, Japan 12, UAE 28, China 37 and the USA 23.

[113] . Frajollah , Afifi, "Impediments to Foreign Direct Investment in Iran"[in Persian], unpublished LLM thesis, Shahid Beheshti University of Tehran, 2005.

typical of their period, have been cited repeatedly as examples of foreign exploitation of the Iranian national resources. This has had an important influence on the creation of a deep xenophobia among the Iranians at least as far as foreign investment in natural resources is concerned[114]. In the wake of the 1979 revolution many industries and huge businesses were nationalized. Many of these nationalizations were done without any compensation paid especially in the case of Iranian nationals who could seek no remedies. This was done mainly as the newly founded Islamic regime had a tendency to distance itself from western capitalism and intended to steer away from anything associated with the Shah regime. There was generally a pessimistic mindset as to the legitimacy of private ownership and there was little respect for Iranian entrepreneurs who were suspected of having become wealthy through receiving rents from the previous regime. One of the main pillars of criticism levelled at the Shah Regime was that his policies had caused economic and political dependence on the west. The revolution revived nationalistic sentiments and given the media propaganda, opposition to foreign capital became part of the Iranian political culture. The government should try to shift public opinion since a prerequisite for attracting investment is a

[114] Resalat newspaper, no 6011, page 16, 24/8/85.

widespread belief in its efficiency and usefulness.[115] Religion has also had its role to play; based on Shia Islam teachings, a Muslim nation should not be dependent in any respect on a non-Muslim country. This principle also manifested itself in The Iranian constitution.[116] In fact, it was mainly on this ground that Iranian politicians had little inclination to use foreign investment in the first decade after the revolution.

4-2. Political impediments:

Main political barriers to foreign investment in Iran include tensions with the west, economic sanctions and a lack of domestic political stability.

4-2-1.Iran west relationships: Maintaining a good relationship with the developed world is an incredibly important criterion especially in today's world when investors are more inclined to make investments in developing countries rather than developed countries so as to make bigger profits. Understanding this trend, developing countries compete with one another for creating more favourable circumstances for prospective investors. This competition is not entirely of an economic

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[115] Mousa Ghani Nejad, Mahdi Navab, "The Challenges of Foreign Investment in Iran"[in Persian] , 2001, http://www.csr.ir/Center.aspx?lng=fa&abtid=06&&nxtid=14.

[116] This is based on a famous Shia principle "La Sabil" literally "no way" which dictates there should be no way for non-Muslims to gain control over Muslim countries. This was one of the principles based on which foreign investment was severely opposed to.

nature and politics should by no means be overlooked. In other words, developing countries which have less tension with developed countries usually have the upper hand and are more likely to be the final destination for foreign capital.

Since the revolution of 1979, there has always been much tension between Iran and the west as a whole. The history of this uneasy relationship can be traced initially in the hostage crisis in 1979. However, this already soured relationship worsened as the war started since many western powers overtly or discreetly sided with Iraq. Iran, not long before a strategic alley of the US, was suddenly an ideologically founded regime which was considered a threat to the interests of the US in the region. The US has used its influence to turn other states against Iran as well. As the strongest economic power in the world, the USA has used political as well as economic leverage to isolate Iran. The US has always accused Iran of having a part in the hostilities in the region and of interfering in the internal affairs of neighbouring countries. Iran has always reciprocated by presenting counter allegations of the same nature. Some recent global developments have served to deteriorate the conditions and have obviously widened the gap between Iran and the west. First, there has been a general distrust of Muslims in the wake of

the 2001 New York terrorist attacks which is even aggravating as extremist Muslim groups continue to threaten the security of the world. The US initiated a war against two of the Iranian neighbours which has understandably placed Iran in a more defensive position. In addition, the seemingly irresolvable Iranian nuclear case has had its important part to play in deepening the gap between Iran and the west; there have been huge economic and political pressure, in the form of Security Council and unilateral sanctions, put on Iran to make it abandon its allegedly ambitious nuclear program. However, it appears that the west has achieved little and Iran is still pursuing its program very rigorously. Last but not least, the election of President Ahmadi Nerjad in the 2005 opened a new chapter in the history of Iran-west relationships and in a way undid all the efforts made by previous Iranian governments to bridge the gap. The Iranian so-called radical president has, on several occasions, touched on a number of contentious and sensitive issues such as the Holocaust, the existence of the Israeli nation and very recently[117] the possible link between the terrorist attacks of the 11th of September and the US government which has caused acrimony and has intensified the animosity between Iran and the West. Needless to mention, the

[117] New York general assembly of the United Nations (September 2010) .

Iranian human rights records which has been in the centre of attention for quite long has allegedly been exacerbating in the last few years especially following the disputed 2009 Iranian presidential election.

4-2-2. Sanctions:

The US has imposed several sanctions on Iran since early 1980s. The initial precedents were sanctions regarding weaponry which were continually imposed throughout the 1980s when Iran was fighting a war against its neighbour Iraq. In 1990s the American congress tried to limit the ability of many international financial institutions in granting loans to Iran. The best known unilateral sanctions against Iran were legislated in the American Congress in an act entitled Iran and Libya Sanctions Act in 1996, better known as the D'Amato-Kennedy Act. The act, which was criticised by many states for its extraterritorial nature, aimed to punish all companies and persons, American or not, who invest more than 40 million dollars in the Iranian energy sector and, therefore, increase Iran’s ability to develop its petroleum resources . The sanctions have intensified and have proliferated much beyond the American borders. Since 2005 there have been a number of Security Council resolutions which put sanctions on the Iranian economy as well. In the last few months, there have also been unilateral sanctions complementing UN

Security Council sanctions adopted by other nations such as Canada, Japan, Korea to name a few.

It seems that despite continual denial on the part of Iranian officials, sanctions have taken a serious toll on the Iranian economy and have particularly served to deprive Iran of much of the foreign investment it needs especially in its energy sector which most sanctions have incidentally addressed.

4-2-3.Political instability:

In the last 30 years different governments in Iran have had sharply different attitudes towards foreign investment. Given the complicated nature of the Iranian regime, this creates a lack of stability for foreign nationals who are considering making investments in Iran. Despite the fact that there is a law concerning foreign investment in Iran, foreign investment has been viewed very differently by different administrations. For instance, the reformists who were in power from 1997 to 2005 put forth their best effort to attract foreign investment, whereas the conservatives, now in power, do not view foreign investment as a necessarily positive thing. These differences of opinion could be potentially very damaging to the interests of foreign investors who may

be victimized by domestic political competitions.[118] This, in itself, could be a discouragement for those planning to make investments in Iran.

4.3. Economic impediments:

The most important challenges faced by investors initially is that there is no specific economic policy in Iran that can withstand the test of time. In fact, as has been the case in the last 30 years, with the change of governments, even the most fundamental of economic programs in Iran might be subject to change depending on the stance of the new government.

In Iran governmental and quasi-governmental organizations play a defining role in the economy even today that many parts of the economy are supposed to be managed by the private sector. In fact, many supposedly private companies are organs related to the government under private cover. This in itself could serve as an impediment for the really independent private sector to grow and succeed. Other problems that can possibly be caused by such interference are a lack of transparency, a harmful monopoly on market information and preferential treatments favouring companies linked to the government.

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[118] "Problems, Impediments and Risks of Foreign Investment in Iran"[in Persian], BoursNegar, 16 June 2007 http://boursenegar.com/newsdetail-fa-2119.html.

However, it seems as the privatization in Iran, following changes to article 44 of the constitution, expedites, these problems are expected to be resolved automatically.

Business happens in a legal context and necessitates an up-to-date legal framework. The most important law governing business in Iran is Commercial Code. Iranian Commercial code is very old and has not been updated for long years [119], which means there are severe shortcomings concerning numerous economic areas namely copyright rules, marine trade, stock market, banking, insurances and etc.[120]

A study carried out by the Research centre of the Islamic Parliament of Iran cites the non-liberal, oil reliant and non-competitive nature of the Iranian economy as the main reason why government attempts to attract investment have not met with success.[121]

The reason for the non-competitive nature of the Iranian economy could reach beyond economics and may even be to an extent cultural. 'For competition to start and continue in a market, there needs to exist the infrastructure, culture and necessary regulations. In many developed countries there have been competition laws for as long as one hundred

[119] The Iranian Commercial Code is an adaptation of The French Commercial Code which dates back to 1807 which is over 200 years ago. There has been very little change in the law since its adaptation in 1930s.

[120] Abbas Karim Zadeh., "Some of the Impediments to Production and Investment in Iran"

[121] Resalat newspaper, no 6011, page 16, 24/8/85.

years turning competition into a familiar and tangible concept. Sherman act in the United States, for example, was passed in 1890. What makes competition extremely difficult to arise on itself out of privatization and market reform in Iran is that it is an alien concept that has never played any part in the country's economy because of the role of the state in the economy. There has never existed a single competition law in Iran and the first ever independent committee entrusted with the task of drafting one has formed only very recently. Therefore, it is unrealistic to expect competition to easily result from market reforms to the extent observed in developed countries and it, obviously, requires more time and energy in Iran'[122]

Another very important reason cited by the mentioned centre has been very high economic risks in Iran reaching a staggering 59 percent[123]. Administrative corruption and bureaucracy could also turn into serious barriers interfering with the legitimate activities of foreign investors. In such a bureaucratic system with little government supervision, companies which are willing to make investments might be subject to discrimination. This might have to do with rent seeking of the

[122] Nima nasrollahi Shahri, "Power Market Reforms and Privatization of the Electricity Industry in the Iranian Energy Sector; an Uphill Struggle?" MPRA working paper.
[123] ibid.

individuals involved in the administrative system of the country.[124] The under development of infrastructures is yet another danger threatening foreign investors; it is obvious that a certain level of economic infrastructures is essential for the success or even operation of many foreign companies. Two areas in which there are serious shortcomings are communication and transportation.

Fluctuations in the rate of foreign currencies could also bring about undesirable consequences for foreign investors. In the case of a sudden and massive increase in the rate of exchange for dollars, the foreign investors might make losses when transferring its capital or profits abroad.

4-4.Legal impediments:

4-4-1.Constitutional law:

There are a number of articles relevant to foreign investment in the Islamic Republic of Iran Constitutional law of 1980. 'According to

[124] "Problems, impediments and risks of foreign investment in Iran".

Article 44 of the 1979 Constitution, all the mother industries are owned and controlled by the state. This article in fact indicated the nationalization of all major industries in the sense that private ownership in these industries were disallowed after the Islamic revolution. However, privatization of most mother industries became legally feasible later on through legislation[125], with the petroleum industry remaining an exception. Thus, even now, the petroleum industry cannot be privatized like, for example, the electricity sector. In fact, Article 44 of the Constitution not only forbids any form of private ownership but also prohibits private participation i.e. investment, be it foreign or domestic since it uses the words “owned and controlled by the state”. The 1987 Petroleum law takes the same policy and explicitly declares foreign investment illegal.’ [126]

However, there have been amendments made to it especially to facilitate privatization. These amendments were mainly done to start a privatization program which is now under way. It should be noted that these amendments excluded petroleum reserves and still foreign direct investment in the petroleum industry is not legally feasible. Buy-back

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[125] . General Policies of Article 44 of The Constitution of The Islamic Republic Of Iran, Exigency Council, 2005.

[126] Nima Nasrollahi Shahri, “The petroleum legal frame work of Iran”.

agreements have been used in the last fifteen years as a mechanism to absorb the needed foreign funding. However, realistically, this mechanism has met only with resounding success. Another important article is article 81 of the Constitution which reads:

"The granting of concessions to foreigners on the formation of companies or institutions dealing with commerce, industry, agriculture, service, or mineral extraction, is absolutely forbidden."[127]

This article can be interpreted in three different ways[128]. Some believe it amounts to a complete prohibition of the establishment of any foreign company in Iran. Another view is that as long as the majority of shares are held by Iranian nationals there should be no problem. An alternative interpretation is that article 81 restricts the prohibitions solely to concessions and maintains that if the word concession is not used there would be no legal ban. Seemingly, the FIPPA favours the latter stance. Further pragmatic amendments to the Iranian constitution deem essential at this stage.

[127] The Constitution of Islamic Republic of Iran, Art 81.
[128] Frajollah Afifi. "Impediments to Foreign Direct Investment in Iran".

4-4-2.Labour law:

The Iranian Labour law was validated at a time when there was an immensely protective attitude towards the labour force[129]. And, therefore, the whole foundation of this law is built upon a conflict of interest between the labourer and the employee which can by no means be conducive to the security of investment, be that foreign or domestic.[130] One of the main problems concern dismissal of workers; employers will have considerable difficulties and face several restrictions when they intend to fire their employees if their performance is not satisfactory. Even when fired, many employees are able to get back to work against their employers' will through using legal means. This has pushed domestic employers to have annual contracts with their labour force so as to be able to discard them once the year is over. Another challenge particularly facing foreign investors is obtainment of work permit for foreign workers which requires going through a very rigorous procedure considering the protective nature of the Iranian law for Iranian workforce.

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[129] "Problems, Impediments and Risks of Foreign Investment in Iran".

[130] Ghani Nejad, Mousa, Navab, Mahdi "The Challenges of Foreign Investment in Iran"[in Persian] , 2001, http://www.csr.ir/Center.aspx?lng=fa&abtid=06&&nxtid=14.

4-4-3.Encouragement of foreign investment law(FIPPA):

This law has indeed filled many of the voids that used to exist in the Iranian legal frame work before its legislation. However, there are still subjects within this law which could be modified. As an example, as mentioned previously, based on the Iranian domestic law, foreign nationals are unable to possess immovable property. This has been reaffirmed in the FIPPA. This can disincentive the prospective investors and is much less favourable when compared with many other countries. However, companies registered in Iran could own immovable property which can solve this problem to a limited extent. Another pitfall is the limitations set for the proportion of foreign investment in different economic sectors. However understandable the logic behind this may appear, such limitations are typically set by countries which are inundated by foreign investment and are thinking of directing this investment to more desirable fields and not by countries like Iran which suffer from a massive shortage.

Conclusion and recommendations:

Like many other countries in Asia such as South Korea, Iran started its industrialization plans in the 1970s. The plans were initially much faster and more successful than those of its peers[131], mainly because of the Iranian huge natural resources endowment. As part of the scheme and to meet the lack of domestic financial resources the country began using foreign investment. However, there was a massive and abrupt change of attitude towards economics after the 1979 revolution. The revolutionary climate of the country along with the war served to bring the industrialization program as well as the attraction of foreign investment to a complete halt. This trend continued for more than 10 years. However, since the beginning of 1990s when more pragmatic governments came into power there have been attempts to get the economy back on track and foreign investment has obviously been an indispensable option. Ever since 1996, the country has reformed its domestic legal framework for investment and has concluded many international treaties to encourage the flow of FDI into the country. There has been some investment in Iran in the last 15 years. However,

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[131] Hossein Askari, The Iranian economy, “Part 1: Iran’s Slide to the Bottom”, Asia Times online , Sep 15, 2010, http://www.atimes.com/atimes/Middle_East/LI15Ak01.html.

they have been far from international standards for a country of the size and natural resources of Iran and have proved clearly insufficient for the development programs of the country.

As discussed earlier, there is consensus among economists that provided certain conditions foreign investment contributes to the economic growth of a country. It is a well-trodden path taken by many countries. There have also been numerous studies that signify international treaties can help attract foreign investment given they are concluded with the right countries.

In the case of Iran, it can be claimed that the attempts have only partly paid off, but despite the increase in foreign investment the records are less than satisfactory. The growth rate of investment has consistently been higher throughout periods when more treaties were concluded. In other words, governments have always been greeted with increases in foreign investment when adopting a more positive attitude towards the matter.

However, it should not be forgotten that since the year 2000, there have been many reforms made to the Iranian legal and fiscal framework for investment and the increase has happened in such a context. Therefore, establishing a causal link between international treaties and foreign

investment in Iran demands more attention and could not be dealt with within the scope of a study of this nature.

However, it appears that for a country like Iran economic openness and political compromise are more important factors than domestic or international efforts of a completely legal nature. As to bilateral treaties, the vast majority of the Iranian treaties are concluded with developing countries and underdeveloped countries which do not tend to be particularly capital exporting. It seems realistic to recommend that there should be more treaties concluded with OECD countries. In addition, having no economic relationships with the United States, the biggest economy of the world, has deprived Iran of an important investment source and has, in turn, taken its toll on the Iranian economy as far as financing is concerned. This has recently even worsened as the relationship between Iran and many other economic giants such as Germany, France and the UK is turning sour.

The problem of foreign investment in Iran seems to be overwhelmingly political; logically, for a political problem one should devise a political solution. The economic sanctions, a significant impediment for investment in Iran, have been imposed on Iran for purely political and partly ideological reasons. After the rise of President Ahmadi Nejad in

2005, the ideological and political tensions between Iran and the west have been heightened and the ideological differences are arguably deeper. It appears that ideology and politics come before economics on the Iranian regime agenda and national interest is not as economically defined as it is for the majority of countries. Politics and economics are inseparable especially in a country like Iran while the economic policies of Iran[132] appear to be incongruous with its political stances. As a result, the economy is usually, at least as far as international relationships are concerned, overshadowed by politics and ideology. This may have to do with its huge oil and gas resources and the fact that, given the high oil prices, the government has a huge, constant and guaranteed income regardless of international political developments.

From a political perspective, an important misunderstanding to be cleared as soon as possible is the Iranian contentious nuclear program. Once this problem is solved, there is a much higher likelihood for Iran to succeed in attracting investment in the absence of international economic sanctions. At this stage, it is very difficult to make any speculations as to the future of investment in the country since it depends largely on the

[132] Examples of such modern policies are the encouragement of foreign investment and privatization of mother industries. In fact the Iranian economy is being modelled on the west while its politics and its view towards international law are increasingly becoming more isolated.

political developments within Iran and the US ; the next Iranian president as well as the next American administration could be key determinants.

Legally speaking, as discussed within the body, to enhance the legal framework some measures such as amendments to employment law and a change in the contractual regime of upstream petroleum agreements can be recommended. It seems that the economic climate in the country is gradually becoming better and more suited to foreign enterprise; an important development to be unfolded in close future is the gradual removal of subsidies which can conceivably serve to expedite privatization and strengthen the private sector. As well as this, it can take a huge burden off the Iranian government shoulder and can probably reform the consumption pattern among the Iranian consumer.

Questions for further studies:

In this study, it was concluded that reforms to the economic and legal framework of the country and concluding treaties with other countries cannot, on their own, solve the problem of foreign investment in Iran and that changes to areas of political significance such as foreign policy seem to be inevitably crucial.

However, because of the limited scope of this study, several questions remain unanswered. First and foremost, more studies should be done on the impact of concluding treaties with third world countries, which are not particularly capital exporting, on the amount of investment channelled to Iran. It should be investigated if these treaties are worth the cost the country undergoes to conclude them if they are only friendly gestures aiming to strengthen political ties with no investment related implications.

Considering the new economic developments in Iran, it should be very interesting to study the effects of the removal of subsidies on foreign

investment. Heavy subsidization of energy and some consumer goods in Iran had been considered by many scholars as an important impediment in the way of privatization and liberalization of the economy and now that subsidies are to become history, studying the potential effects of this massive economic program on foreign investment requires academic attention.

On the political side, whether Iran can succeed in taking its development path without making fundamental changes to its foreign policy i.e., its relationship with the west, requires more in depth analysis in a more political context. However, it should be mentioned that such a study involves much speculation and, therefore, is not likely to lead to conclusive results. This is especially true given the importance of political changes, which incidentally seem to be occurring at a much rapider pace than ever before globally, and the way they unfold for the fate of Iran and its rivals, one may say enemies.

If the present trend is to continue, the author believes that more studies should be done on alternatives to foreign investment as far as the development of the petroleum resources is concerned. Alternatively, adopting a more attractive contractual regime such as a classic production sharing regime for development of petroleum reserves can be

an option worth considering. It can be speculated that oil may lose its current relevance in some decades and so Iran should consider expanding its production capacity to maximize profits as long as each barrel of oil can fetch a price much higher than its production cost leaving enormous rent for the country.

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