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Trade Policy Roundtable

Extending the WTO System to Investment

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RICHARD EGLIN is one of the senior permanent staff at the World Trade Organization, where he is the Director of the Trade & Finance Division, having earlier headed the WTO's Development Division (1997-98). Earlier still he was the Director of the Trade & Environment Division (1991-96) when, under the General Agreement on Tariffs and Trade (GATT), the Committee on Trade and Environment was established. Dr Eglin has had articles published in various professional journals and has contributed to a number of volumes of essays, including Jagdish Bhagwati and Mathias Hirsch (eds), *The Uruguay Round and Beyond*, in honor of Arthur Dunkel (1998). His article in the March 1987 number of *The World Economy* on "Surveillance of Balance-of-Payments Measures in the GATT" led to the little-noticed Uruguay Round understanding that saw the end of GATT Article XII being mis-used to maintain general import restrictions long after their balance-of-payments difficulties had been resolved.

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Trade and Investment in the WTO System

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{*Speaking Notes for the Cordell Hull Institute's Trade Policy Roundtable*)

AT THE first WTO Ministerial Conference, held in Singapore in December 1996, WTO Members agreed to begin work of an analytical nature on the "Relationship between Trade and Investment". The WTO Working Group responsible for this subject met regularly to examine the links between trade and investment from several points of view, including the contribution of foreign investment to development and economic growth, and the potential advantages and disadvantages for WTO Members of bilateral, regional, and multilateral rules on investment.

Work Programme on Trade and Investment

Five years later, in November 2001, WTO Ministers meeting in Doha, Qatar, recognized "the case for constructing a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment", and gave the WTO a new and much more ambitious mandate in this area. They agreed that negotiations in the WTO on an Investment Agreement would take place after the fifth Ministerial Conference, scheduled to be held in Cancun, Mexico, in September, "on the basis of a decision to be taken, by explicit consensus, at that session on the modalities of negotiations". They instructed the WTO Working Group, in the period up to the next Ministerial Conference, to focus on clarifying a number of core issues[1] related to a possible WTO Investment Agreement, and set out several general issues that needed also to be addressed, in particular incorporating a solid "development dimension" into an Investment Agreement, protecting governments' "right to regulate in the public interest", and ensuring that a new Investment Agreement would be compatible, architecturally, with other WTO Agreements (such as the GATS) and with existing bilateral and regional investment agreements.

Moving from an analytical work programme in the WTO on this subject to a more focused process of exploring the parameters of a possible multilateral agreement on Investment has not been uncontroversial. Since 1999, proponents of WTO negotiations on investment, notably the European Union, have met with opposition from a number of developing countries, notably India, who are against the idea of extending the rules-based WTO trading system to cover foreign investment. Nor is it yet clear that a WTO negotiation will indeed take place. That will depend upon WTO Ministers giving a green light to start negotiations when they meet in Cancun on September 10-14.

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[1] These are: scope and definition; transparency; non-discrimination; modalities for pre-establishment commitments based on a GATS-type, positive list approach; development provisions; exceptions and balance-of-payments safeguards; and consultation and the settlement of disputes between Members

Nonetheless, it is clear that the WTO's work programme on investment has moved into a higher gear since the Doha Ministerial Conference. It has been important that preparatory work before the Cancun Ministerial Conference, including our greatly expanded programme of technical assistance activities in this area, help all WTO Members to evaluate the implications of closer multilateral cooperation on investment for their own economies, and particularly for their development policies and objectives, so that they are able to approach the decision that will need to be taken in Cancun with confidence and on the basis of a thorough understanding of the subject.

WTO Rules and Foreign Investment

Foreign investment is treated as one of the "new issues" on the WTO's work programme, yet close links have always existed in commercial terms between international trade and foreign investment. So it is not surprising to find that a number of the WTO agreements already touch on foreign investment too. These include the agreements on TRIMs, TRIPS, Subsidies and Government Procurement. The most important is the General Agreement on Trade in Services (GATS), and its rules relating to the establishment by a foreign service supplier of a "commercial presence" in an overseas market. Commercial presence is GATS-language for foreign direct investment (FDI), so that in this respect foreign investment is already partly covered by the WTO framework. But its coverage is far from complete, most obviously for foreign investment in the agricultural, mining and manufacturing sectors; and even the GATS falls far short of providing the kind of treatment for investment protection and promotion that is characteristic of international investment agreements, particularly the multitude of bilateral investment treaties that exist today.

Interest among WTO Members in the subject of trade and investment, and in exploring the potential benefits that might derive from negotiating a multilateral investment agreement in the WTO, can be explained by two factors in particular: (i) the growing importance of foreign investment in the world economy, and (ii) the complementarity of trade and investment policies.

Growing Importance of Foreign Investment

Huge opportunities for foreign investment to expand globally have developed in the 1990s, in the context of world-wide trade liberalisation and the growth and integration of international markets for traded goods and services. Annual flows of FDI have been growing substantially faster than world trade. In 2001, new FDI flows exceeded $750 billion, about $220 billion of which represented inflows to developing countries[2].

WTO Members, especially developing countries, value the contribution of FDI to their economic growth and development, for two reasons in particular.

- FDI brings <u>long-term foreign capital</u> into the economy. Compared with foreign bank loans and bond financing, the capital inflow associated with

[2] UNCTAD, TAD/INF/PR36, 21 January 2002. New FDI flows in 2000 had reached a record of $1,300 billion, but this total was heavily inflated by a number of very large cross-border mergers and acquisitions which took place in that year.

FDI is more stable, it involves no fixed interest payments nor fixed capital repayments, and it is invested directly into productive capacity.

- FDI brings with it <u>a bundle of productive assets</u>, particularly entrepreneurship, technology, and managerial and export marketing know-how. These are valuable for increasing productivity and diversifying economic activity in developing countries. FDI represents often the most economical way, and sometimes the only way, for developing countries to acquire these assets.

Complementarity of Trade and Investment Policies

In the past ten years, many developing countries have improved significantly their ability to attract FDI through changes in their trade and investment policies. Trade policy can be at least as important as investment policy in this respect, since most FDI is trade-related, and much of it is very trade-intensive indeed, either in substituting for imports or in generating exports. Today, about one-third of international trade consists of transactions between multinational enterprises and their subsidiaries, and another third consists of their trade with suppliers. Both trade and investment policies, therefore, have a lot to do with the <u>amount of FDI</u> a developing country can hope to attract on a sustained basis, as well as with the <u>quality of productive assets</u>, such as improved technology and increased export capacity, that it can expect to derive from FDI.

Outside the particular case of FDI in the extractive industries, such as mining and petroleum, the more restrictive is a host country's trade policy, the more likely it is, generally speaking, that if it comes at all, FDI will focus on supplying the domestic market rather than on producing for export. Domestic market size is then one of the principal determinants of the amount of FDI which the host country will be able to attract. This is an important part of the explanation of why FDI largely by-passes many smaller countries, notably in Africa. Once established, FDI will naturally have to compete with local suppliers, but in a restrictive trade environment it will be protected against competition from imports and it not obliged to live up to world standards of quality or efficiency. In these circumstances, a foreign investor may conclude that a second-rate bundle of productive assets will suffice, and the host country can end up receiving only obsolete technology and no improvement in its export capacity.

By contrast, host countries with liberal trade policies can hope to attract FDI both to supply the domestic market and to export. Also, a foreign investor is more likely in a competitive business environment to bring in a first-rate bundle of productive assets (state-of-the-art technology and entrepreneurial know-how). As long as the investment proves to be a commercial success, there will be incentives for the foreign investor to keep the technology and know-how up-to-date, and to encourage its diffusion through backward and forward linkages to local industry.

In addition to factors such as the size of the domestic market and the trade policy environment, investment policies play an important role in determining the amount and the quality of FDI that a host country is likely to attract.

For the foreign investor, FDI represents not only a source of profit but also a source of risk. Policies that lower the risk involved will help to attract FDI. Business surveys suggest that foreign investors favour host countries where FDI policies are transparent and predictable, which provide protection against discriminatory treatment, and which provide an open and competitive business environment. These are all factors that contribute to reducing a foreign investor's commercial risk, and increasing the attractiveness of a country as a host for FDI.

Naturally, a host country government will want to extract from FDI the greatest contribution to growth and development of its economy. It may wish to attract FDI in certain industries, but not in others; it may wish to take precautions against large foreign corporations crowding out small and medium-scale domestic firms; it may wish to encourage a foreign investor to develop strong backward and forward linkages to local business; and so on.

FDI policies need to balance these two perspectives. They are not incompatible. Many developing countries have introduced new FDI policies in the past ten years, aiming both to attract more FDI and to ensure it contributes to domestic growth and economic development.

Existing Bilateral Investment Treaties…

Internationally investment agreements have to accommodate this essential balance, between rules-based policy obligations, on the one hand, and flexibility for host countries to pursue their domestic economic and development policies, on the other.

International policy obligations help to reduce investors' risk, and in particular to narrow the gap between the actual risk of policy instability that is suggested by a host country's domestic legislation, and the perceived risk of foreign investors. The perceived risk is often much higher than the actual risk; binding international obligations help the two to converge.

International rules also help host countries to create and maintain domestic "policy space" in which to pursue their national economic and development objectives. In an interdependent global economy, sovereignty is constrained not by international rules, but by the absence of these rules. Negotiating international investment agreements is not synonymous with surrendering national economic sovereignty to global capitalism, but rather the reverse – exercising it. Evidence of that is the huge number of bilateral investment treaties that have been negotiated (more than 2,100 today), many of them in the past ten years, and most of them between industrialized countries and developing countries. Both parties must feel there is a benefit to be gained from doing so.

…and a Possible WTO Agreement

The issue facing WTO Member countries, therefore, on which they will need to decide in Cancun, is not so much whether they want to bind their investment policies under international investment agreements – the proliferation of bilateral investment treaties shows clearly that the vast majority of them do – but whether they prefer to continue to forge these agreements bilaterally, and perhaps in some instances regionally too, or to consolidate a large part of the exercise through one single multilateral agreement to be administered under the

WTO. That is the issue that WTO Members are debating in the Working Group on the Relationship between Trade and Investment in Geneva.

The Pros…

The proponents of negotiating a WTO agreement on foreign investment point to a number of advantages that they feel would accrue.

One has to do with the perceived weaknesses of continuing to base international economic cooperation on a bilateral or regional approach in an area that is as important for all WTO Members, and that is expanding as quickly, as FDI. FDI does not flow bilaterally – it is perhaps the most striking and powerful economic force involved in "globalisation", and it needs to be addressed by policy-makers from an international perspective. This is much the same line of argument that led governments to decide fifty years ago to consolidate their many separate bilateral and regional trade agreements into the multilateral trading system under the GATT.

Among the weaknesses of a bilateral approach are the following.

- Smaller and poorer countries are at a distinct disadvantage when negotiating bilaterally with their major economic partners – in a multilateral negotiation, developing countries are able to pool their influence and interests.

- Bilateral and regional treaties marginalize – in some cases can damage, third country interests, since they are inherently discriminatory in nature.

- Bilateral investment treaties can be costly to negotiate and administer – over 10,000 separate agreements would be needed if all WTO Members were to sign bilateral investment treaties with each other.

- And the provisions of bilateral treaties are not standardized, leading to uncertainty, potentially inconsistent rules, and legal conflicts.

The proponents also believe that a WTO Investment Agreement would increase global flows of foreign investment, particularly FDI. They base their case on the argument that multilateral rules in this area would reduce investors' risk, and that an agreement should make provision for liberalising market access for foreign investment. As the proponents recognise, however, it is important not to exaggerate claims of increased FDI flowing from a WTO agreement in this area. There are grounds for believing that providing home and host countries and investors with greater legal certainty about the policies and regulations that apply to FDI, along with more open access to host countries, will encourage more FDI. However, just as is the case with trade, nothing reliable can be said *ex ante* about which WTO Member countries can expect to record an increased inflow of FDI. Although the overall total can be expected to grow, the distribution of FDI world-wide will depend upon country-specific factors.

More generally, the case for bringing rules on FDI into the WTO is to allow WTO Members to cooperate more effectively with each other in applying their domestic investment policies. As economic interdependence increases, governments need clear and consistent rules to help them work out ways to achieve their policy objectives cooperatively – rules that will discourage discrimination, and encourage more transparency, more stable and predictable policies, and a more liberal investment environment, so as to enhance the benefits that WTO Members derive from their participation in the world economy.

...and the Cons

The case set out by the proponents of WTO negotiations on investment is not accepted by all. Some WTO Members remain firmly opposed to bringing investment into the rules-based WTO system.

They feel that, to the extent international rule-making for FDI is needed at all, bilateral and regional arrangements are the more attractive and development-friendly way of proceeding. Bilateral treaties can help reduce commercial risk for foreign investors, while maintaining the host government's control over foreign investors' business activities. Allowing each treaty to be negotiated separately leaves host countries with a good deal more flexibility than would be the case in a multilateral negotiation in the WTO. In particular, most bilateral treaties cover only the post-establishment stage of a foreign investment, leaving the pre-establishment stage – the market access stage of admission and establishment – to be dealt with unilaterally by host countries, according to their domestic development objectives.

They feel, too, that the case for negotiating a multilateral agreement is far from proven. They point to the success that countries such as China have had in attracting FDI, without there being any multilateral framework of rules in place, and do not believe that a WTO agreement would lead to increased flows of FDI to developing countries.

In conditions of imperfect competition, views differ on how FDI may affect the development of individual economies. Notwithstanding the fact that most studies find on balance the impact is strongly positive, some Member governments are persuaded that the costs of liberalising access for foreign investors, and of limiting government control over their activities once they have established locally, can outweigh the benefits involved.

Is There a Middle Ground?

At this point in time, it would be foolhardy to comment on the likelihood of a political decision being taken at Cancun on whether or when to start negotiations on investment in the WTO. Nor can anything meaningful be said about the meaning of the term "modalities" in the Doha mandate; this will be a matter for WTO Members and Ministers to decide on.

Nonetheless, at a technical level, one can speculate on whether, in principle, an approach could be designed that would accommodate the needs of both the proponents and the opponents of WTO negotiations.

One possibility, that was briefly discussed but rejected before the Doha Ministerial Conference, would be an opt-in/opt-out approach, through which those WTO Members that did not wish to participate in the negotiations, or that did not wish to sign onto any result reached, would not be obliged to do so. This possibility was rejected by many developing and developed country Members, in particular because of the systemic threat that it could pose to the integrity of the WTO's multilateral character. Moving back towards a plurilateral approach in selected areas, as was done in the 1970s in the Tokyo Round, would signal a failure of the consensus principle that binds WTO Members and the multilateral trading system together, and could easily impact adversely on the trade and investment interests of those Members that choose to opt-out (or not to opt-in), in particular the smallest and weakest among them. Even if it were agreed up front that these Members would enjoy full MFN rights, on a non-reciprocal basis, under any eventual investment agreement, the effect would be to create two "classes" of Members, one with obligations and one without, which would send a confusing signal to potential foreign investors and could lead them to avoid investing in Members who had chosen to opt-out.

A second possibility would be to design a framework agreement in the WTO, to which all WTO Members would be signatories, that would provide sufficient flexibility to allow each Member to make individual, legally-binding commitments that are consistent with its individual needs and capabilities. It could be felt that something of this kind was in the minds of the drafters of the Doha mandate on Trade and Investment, which speaks in Paragraph 22 of:

> *"The special development, trade and financial needs of developing and least-developed countries should be taken into account as an integral part of any framework, which should enable Members to undertake obligations and commitments commensurate with their individual needs and circumstances"*

What might such a framework look like?

On the basis of the discussions that have taken place in the WTO Working Group to date, it would seem that it would need to make provision for binding rules on both foreign <u>direct</u> investment and foreign <u>portfolio</u> investment, and on <u>pre-establishment</u> treatment and <u>post-establishment</u> treatment, if it were to meet with the approval of some Members who are seeking a high level of ambition from any WTO agreement in this area. At the same time, it would need to provide other Members, particularly developing countries, with an assurance that they could tailor their commitments and obligations to their particular needs and circumstances. For some, this would imply the need for sufficient flexibility in applying the framework to allow them to undertake commitments only in the area of foreign <u>direct</u> investment, only with respect to the <u>post-establishment</u> treatment of FDI, and only on the basis of a <u>positive</u> list approach to commitments that would allow them to start gradually to build up their international obligations in this area.

Diagrammatically, the structure of the agreement might then look something like the attached table. The overall framework would be large enough to accommodate a high and wide level of rights and obligations for those Members seeking an ambitious agreement, but each Member would have the possibility of filling in as much – or as little – of the picture inside the frame as was felt to be consistent with its particular stage of economic development. Exactly what that "picture" would look like would of course be a matter for negotiation. One might speculate that the OECD countries would be willing to fill in most, if not all, of the picture, while many developing countries would be filling in much less, to start with at least. An important consideration would be to ensure that no matter how much a developing country decided to fill in, it would nonetheless benefit in full from the obligations undertaken by other Members.

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<tr><th colspan="7">POST-ESTABLISHMENT TREATMENT</th><th colspan="7">PRE-ESTABLISHMENT TREATMENT</th></tr>
<tr><td>Most-Favoured Nation Treatment</td><td>National Treatment</td><td>Transparency</td><td>Development Provisions</td><td>Balance-of-Payments Safeguards</td><td>Exceptions</td><td>Other</td><td>Most-Favoured National Treatment</td><td>National Treatment</td><td>Transparency</td><td>Development Provisions</td><td>Balance-of-Payments Safeguards</td><td>Exceptions</td><td>Other</td></tr>
<tr><td colspan="7">Foreign Direct</td><td colspan="7">Investment</td></tr>
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