

Scaling Back Ambitions on Investment Rule-Making at the WTO

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The subject of considerable discussion and analytical work in the WTO since the establishment of a Working Party on the Relationship between Trade and Investment at the December 1995 Singapore Ministerial meeting, investment rules will almost certainly be an important agenda item for consideration at the WTO's forthcoming Ministerial meeting in Doha, Qatar. Before describing what the substantive content of a possible set of WTO-anchored rules on investment might consist of, it bears recalling at the outset what core objectives investment rules typically pursue and how these may play out in the WTO in the light of some of the policy lessons governments have learned in the context of negotiations on a Multilateral Agreement on Investment (MAI), which OECD countries abandoned in 1998, as well as under Chapter 11 of the North American Free Trade Agreement (NAFTA). In the main, investment rule-making concerns itself with five main objectives:

- (1) promoting a more secure, predictable and transparent environment in which to plan and operate cross-border investments;

- (2) ensuring greater protection for investors and their investments;

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- (3) promoting the progressive liberalization of barriers restricting the entry and conduct of foreign firms in domestic markets;
- (4) reducing or eliminating measures that distort trade and investment decisions and reduce allocative efficiency; and
- (5) developing credible institutions and rules for solving potential disputes.

The brief discussion that follows shows how it may be useful to cluster protection and dispute resolution issues on the one hand, and liberalization and distortion matters on the other, in mapping out what may usefully be done in addressing the trade and investment interface at Doha and beyond.

Investment Protection and Dispute Resolution

The subject of some 1850 existing investment treaties, more than half of which were concluded in the last decade, investment protection had until the advent of the NAFTA and the MAI been conducted almost exclusively on a bilateral, North-South, basis.

The MAI negotiations, and the NAFTA before (and after) it, have revealed just how encompassing investment protection treaties can be. Both have shown how the juxtaposition of (i) a broad definition of investment; (ii) far-reaching protection against expropriation, including compensation for investors in the advent of “indirect” forms of expropriation (so-called “regulatory takings”); and (iii) private party recourse to dispute settlement, i.e. investor-state

arbitration, can give rise to complex, politically sensitive, and often unanticipated policy challenges when pursued among countries with a long history of regulatory activism.

The lesson has been sobering, suggesting that what works well and is fairly uncontroversial within highly asymmetrical power relations and when investment flows are unidirectional in nature, looks considerably less attractive, and indeed more problem-prone, when applied to countries with significant two-way investment ties and where internationally-active firms have an equal ability to defend their property rights in each other's (or before international) courts.

Viewed in this light, it is not altogether surprising that many countries have shown growing hesitancy on the issues of how broad to define investment; whether a political market exists in support of *multilateral* investment protection disciplines (and if so, how broad such disciplines should be on expropriation grounds); and whether, all things considered, private investors should be allowed to challenge state conduct and afforded direct standing in dispute resolution proceedings. Paradoxically, such questioning is taking place at a time when bilateral investment treaties that feature many of the provisions that undermined the MAI negotiations and are proving controversial in a NAFTA and WTO setting, are being signed in record numbers. Indeed, in a context of worldwide unilateral investment regime liberalization, many host countries in the developing world have come to appreciate the "signaling" benefits afforded by bilateral investment protection agreements. The latter send clear signals to international investors that recently enacted policy reforms are unlikely to be reversed, thereby reducing risk premia for investors. A growing number of such agreements has in recent years been reached among developing countries.

Investment Liberalization/Discrimination vs Investment Distortions

While discriminatory barriers affecting entry and the scope of company operations once established can clearly distort trade and investment decisions, it is conceptually useful for rule-making purposes to distinguish between liberalization and distortion issues.

The challenge of investment regime liberalization – of removing discriminatory barriers that constrain the ability of foreign investors to contest a domestic market (both before and after entry) - concerns almost exclusively the service sector. Indeed, few countries maintain economically meaningful restrictions on entry in manufacturing (to which the bulk of non-service FDI is directed). Quite the contrary, they are often willing to provide better than national treatment and lavish fiscal incentives to lure such investment.

However, discriminatory restrictions are commonplace in sectors such as finance, transport, energy, broadcasting, and telecommunications. To a considerable extent, the real theatre of investment regime liberalization is services-specific. Evidence of this is found in the negative lists of non-conforming measures produced by Chapter 11 of the NAFTA or the draft reservations lists generated in the MAI context, both of which reveal the overwhelming degree (in excess of 80% of listed measures) to which investment liberalization involves services activities. It bears recalling, moreover, that services comprise close to 70% of annual FDI flows worldwide.

That being the case, it should come as no surprise that a number of observers have come to argue that the progressive liberalization of investment regimes may be best secured through

“patchwork” efforts anchored in the GATS.² The above consideration also suggests why the idea of anchoring future WTO investment discussions in the TRIMs Agreement (a possibility foreseen in Article 9 of the Agreement), whose scope relates solely to investment measures affecting trade in *goods*, is unlikely to be satisfactory from an investment liberalization perspective.

In contrast to discriminatory barriers on entry and operation, measures that produce investment-distorting effects and result in allocative inefficiencies concern almost exclusively manufacturing activities (and to a significantly lesser extent the primary sector). Consisting mainly of performance requirements and investment incentives, such measures draw attention to the scope for, and practical means of, broadening the remit of the Agreement on Subsidies and Countervailing Measures (SCM Agreement) and Agreement on Trade-Related Investment measures (TRIMs Agreement). In so doing, they also recall the scope that does exist within the WTO’s current architecture for pursuing a patchwork approach (anchored in existing agreements) to rule-making rather than crafting a generic set of *de novo* rules.

There is little doubt that some room does exist within the SCM Agreement to challenge distortionary investment incentives.³ Yet this disciplining space has so far never been used, prompting the question of the existence (or not) of a political market, especially in federal countries, for introducing credible multilateral disciplines in this area. With the exception of the European Union’s treatment of subsidies (state aids) under its competition policy regime, the international community has on repeated occasions revealed a marked preference for rule-making inaction on this front. The MAI illustrated this point quite vividly most recently. Still, a number

² See Pierre Sauvé and Christopher Wilkie (2000), “Investment Liberalization in GATS”, in Pierre and Robert M. Stern, eds. *New Directions in Services Trade Liberalization*, Washington, D.C.: Brookings Institution Press and Center for Business and Government, Harvard University, pp. 331-363. See also Bernard Hoekman and Kamal Saggi (1999), “*Multilateral Disciplines for Investment-Related Policies?*”, Paper presented at the conference “Global Regionalism”, Istituto Affari Internazionali, Rome, (8-9 February).

of WTO members, particularly from developing countries, have in submissions made to the Working Group, argued that disciplines on investment incentives should form part of any new package of multilateral investment rules.

In seeking answers to why it has proven so difficult to date to develop meaningful disciplines on investment incentives, it is useful to recall the distinction between efficiency- vs. market-seeking motivations for foreign direct investment. Despite much talk about increased capital mobility and the increasing dispersion of globalized production activities, geography has hardly ceased to matter. The latter motivation (i.e. the search for new markets) continues to predominate in manufacturing. This is particularly so in those industries where investment incentives and associated TRIMs, as well as a host of other non-tariff barriers (e.g. product standards) abound, such as automobiles, chemicals, petro-chemicals, information technology (e.g. computers, micro-processing).

To a considerable degree, available empirical evidence suggests that locational competition and the distortion it entails is most likely felt intra-regionally, rather than inter-regionally.⁴ Such a tendency generally reduces the political demand for introducing disciplines on incentive bidding. In turn, the greater intra-regional intensity of locational competition for FDI draws attention to the potentially distortionary effects of regional integration agreements (particularly free trade areas) on investment patterns. There is, indeed, little doubt that some of the rules commonly found in RTAs – ranging from recourse to strategic anti-dumping, to the

³ See Pierre Sauvé (1997), “Qs and As on Trade, Investment and the WTO”, in *Journal of World Trade*, Vol. 31, No. 4, (August), pp. 55-79.

⁴ See Theodore H. Moran (1998), *Foreign Direct Investment and Development: The New Policy Agenda for Developing Countries and Economies in Transition*, Washington, D.C.: Institute for International Economics and Edward M. Graham (2000), *Fighting the Wrong Enemy: Antiglobal Activists and Multinational Enterprises*, Washington, D.C.: Institute for International Economics.

development of discriminatory sectoral rules of origin, can significantly distort trade and investment patterns.

On the TRIMs front, an important question confronting the multilateral community concerns the actual scope of the Agreement. Stated succinctly, there is a clear need to determine with greater legal certainty how “illustrative” the Agreement’s Illustrative List of prohibited measures actually is. To the extent that the Agreement essentially codified the incompatibility of performance requirements with Articles III (National Treatment) and XI (Prohibition of Quantitative Restrictions) of the GATT, it may well be that the scope of the TRIMs Agreement is broader than is commonly assumed. Compliance with the Agreement, notably its transparency requirements, having proven somewhat difficult to date, this is hardly a trivial question. Indeed, should the Agreement be deemed to cover more types of distortive measures than WTO members currently assume, this would doubtless heighten calls for re-balancing an Agreement which many developing countries consider inimical to their development needs. At a minimum, it could lend additional weight to the strong chorus of developing country calls for extending the 5 and 7-year transition periods foreseen (for developing and least developed countries) for making inconsistent TRIMs WTO-compatible.

Towards a de Minimis Negotiating Mandate in Doha?

There are strong grounds to believe that investment is likely to form part of any broadened negotiating mandate required to launch a new round of multilateral negotiations in Doha. One important reason for reaching such a conclusion owes to the fact that the Uruguay Round’s built-in agenda of resumed negotiations on agriculture and services is widely seen as too narrow to command much enthusiasm among the WTO’s diverse community and allow for an

acceptable balance of benefits to derive from the negotiating process.⁵ The search is thus on for the optimal size and content of a negotiating mandate capable of bringing all key stakeholders back to the table. Given the role of investment as the leading integrative force in a globalizing world economy, the fact that the world's policy landscape towards FDI has been strongly liberalizing during the last decade, and in light of extensive preparatory work at the inter-governmental level (to say nothing of considerable negotiating experience gained in recent years at the regional level), it would be somewhat of an anomaly that a new round of multilateral negotiations commence without some effort at addressing the trade-investment interface more comprehensively.

That said, there is little denying that the recent years have seen a significant scaling back of ambitions on the trade and investment front. The reasons for such changed atmospherics are multiple, and include the disappointing outcome of attempts at crafting a far-reaching Multilateral Agreement on Investment at the OECD; the growing assertiveness of civil society opposition to trade and investment liberalisation and its claim that multinational corporations stand to be the only beneficiaries of investment regime liberalisation; rising concerns over the perceived challenge to regulatory sovereignty flowing from the operation of investment protection and dispute settlement disciplines under the investment chapter of the NAFTA; as well as the desire of many developing country members of the WTO to see their Uruguay Round implementation concerns, including those arising under the TRIMs Agreement, properly addressed before any expanded negotiating agenda is considered.

For these reasons, WTO members will likely be considering the scope for a more modest negotiating mandate on investment in Qatar. A scaled-back set of ambitions, which seems to have

⁵ See Mike Moore (2001), "Why the world needs a new round of trade talks", in *OECD Observer*, No. 226/227, (Summer), pp. 34-35.

gained currency among the majority of delegations that have so far tabled proposals on trade and investment in the WTO (including that of Japan and the European Union), constitutes a significant retrenchment from what OECD countries were prepared to contemplate only a short while ago in context of the MAI negotiations.

A *de minimis* approach would likely feature the following six core elements:

- (1) a *narrow definition of “investment”*, limited to foreign direct investment (investment which entails either commercial presence, lasting interest and/or managerial control) and excluding portfolio investment and other types of assets (e.g. intangible assets, contracts) covered by the “broad” definitions typically found in bilateral investment protection agreements;
- (2) a focus on *strengthened conditions of transparency* in the development, promulgation, implementation and enforcement of domestic rules governing the entry and post-entry operations of foreign established enterprises;
- (3) a predominant focus on *post-establishment investment liberalization* issues, aiming at the progressive application of national treatment, and excluding disciplines on investment protection (which from the perspective of FDI-originating countries are most likely best dealt with in a bilateral setting); with the possibility of a GATS-like, voluntary approach to commitments on pre-establishment matters;⁶

⁶ A GATS-like, *à la carte*, approach could also be envisaged with regard to a minimum set of investment protection disciplines dealing inter alia with unimpeded payments and transfers, expropriation and compensation, protection from strife, general exceptions, etc. WTO members might also need to consider the need for an investment equivalent of GATT Article 24 or GATS Article V (which are WTO-sanctioned departures from MFN treatment arising from regional trade agreements), whose purpose would be to allow members to conclude more comprehensive and extensive investment protection agreements on a bilateral or regional basis without extending the benefits of such agreements on an MFN basis to all WTO members.

- (4) providing for WTO-like, *state to state, dispute settlement procedures*, and excluding private party recourse to dispute resolution procedures, e.g. so-called investor-state arbitration;
- (5) following a *GATS-like, hybrid approach to scheduling liberalization commitments*, with bound commitments undertaken voluntarily in sectors and sub-sectors, subject to the retention (and progressive elimination) of existing non-conforming and/or discriminatory measures; and
- (6) *a focus on the development dimension of the trade and investment interface*, including up-front commitments for technical assistance and capacity-building on the part of the FDI-originating countries and a commitment to assess the developmental effects of the TRIMs Agreement.

A credible argument can be made that a *de minimis* approach along the lines just described would represent an important step forward in multilateral rule-making, embedding a more solid foundation on investment than is currently the case and allowing for a further deepening and broadening of disciplines in subsequent WTO negotiating rounds. Such an argument cannot be easily dismissed, and proposals that call for a scaled back effort on trade and investment should be taken seriously.

That said, there is little doubt that much of this scaling back may well represent an excessive reaction to the demise of the MAI and to perceptions of structural flaws in Chapter 11 of the NAFTA. That several OECD governments experienced significant policy trauma in the MAI context leaves little doubt. The question arises, however, of the extent to which those governments have conducted a proper, sober, analysis of the underlying causes of the MAI's

failure (and of the NAFTA's putative failings) and determined how best to avoid a repeat performance in the WTO. Significantly emaciating the realm of what may be doable on investment at Doha could well be excessive, premature and potentially counterproductive in the absence of such analysis. For this reason, should a negotiating mandate prove elusive in Qatar, WTO Members should agree to renew the mandate of the Working Group on the Relationship between Trade and Investment until the next Ministerial gathering.

Much as a *de minimis* scenario represents a credible option for Ministers to consider at Doha, it is not altogether devoid of problems or conceptual inconsistencies. For one, its focus on a limited agenda of generic rule-making on investment appears to assume a degree of architectural overhaul that WTO Members have not yet addressed in the Working Group, let alone digested or reached consensus on.

It is, indeed, quite unclear how *existing* WTO disciplines would relate to and cohere with any *de minimis* set of investment rules. Would the TRIMs Agreement be incorporated by reference? Should its scope extend to investment measures affecting trade in services? How would the TRIMs Agreement's scope of prohibited measures be modified and/or expanded? Would provisions from the SCM Agreement pertaining to investment be treated in a similar vein? If so, would Ministers not wish to map out some negotiating objectives in this difficult area before agreeing to anything? On the basis of what prior WTO work could such objectives be drawn up? How would the treatment of commercial presence in the GATS co-exist alongside a potentially generic set of *de minimis* investment disciplines? In particular, how would the fairly broad definition of commercial presence contained in the GATS (focusing on both matters of pre- and post-establishment) cohere with the narrower definition envisaged in a possible new WTO instrument? How keen should WTO members be to agree on a GATS-like approach to investment liberalization? How willing should they be at this stage to forego the possibility of a negative list

approach to liberalization for investment (and the demonstration effect that might have for subsequent GATS reform)? Were a *de minimis* set of investment disciplines to focus solely on measures affecting trade in goods, what kind of impediments would liberalization discussions address?

There remains, as well, the thorny issue of the treatment of labor and environment-related issues in any WTO set of disciplines on investment. Political support for investment rules may be weak enough in some key OECD countries as to require a compensatory bargain to be struck to assuage labor and environmental groups. This could take the form of calls for a binding provision committing WTO members not to lower their labor or environmental standards with a view to attracting investment. As in the NAFTA (where such language is not however legally binding), such a commitment could be subject to dispute settlement in the case of a recurring pattern of lax or non-enforcement of domestic standards. It could also lead either to retaliatory trade sanctions or to the levying of monetary fines against offending countries.⁷

Much as a commitment of this type would appear relatively painless for most OECD countries, to whom the bulk of world FDI flows is destined despite their maintaining the very highest standards of environmental and labor protection, there is little doubt that adding provisions of this type would harden the resistance of developing countries towards more comprehensive investment rule-making in the WTO.

⁷ The suggestion has also been made that a WTO set of investment rules should also include provisions, most likely of a non-binding character, dealing with matters of corporate social responsibility, recalling that the rights of investors need to be balanced with certain obligations towards the communities they operate in and the workforces they employ. Precedents for provisions of this sort can already be found in the United Nations' Global Compact or the OECD's recently revised Guidelines on Multinational Enterprises. Unlike the issue of labor standards, this may well be one area where the interests of OECD-based NGOs and trade unions coalesce with those of their developing country counterparts (including in some instances some developing country governments).

A final, open, question concerns private sector attitudes towards proposals for a scaled-back effort on investment at the WTO. It bears recalling in this regard that the business community has in many countries come to view the bilateral route as offering superior returns on scarce negotiating efforts on protection matters while professing considerable interest in transparency-related issues. In some OECD countries, the latter objective appears to have assumed equal importance to that of addressing investment distortions or discriminatory impediments to entry and operation, all the more so as internationally active firms are often able to internalize the costs imposed by the latter barriers and that host countries have on the whole shown little inclination, in an environment characterized by considerably heightened capital mobility, to reverse the course of policy once they embark on the path of significant investment regime liberalization.