From Singapore to Cancun: Investment

Among the many questions that WTO ministers will take up in their September meeting in Cancun, Mexico, is the issue of an international investment agreement. This is one of the four issues under discussion since the Singapore Ministerial of 1996. WTO Ministers in November 2001 chose to launch negotiations on a multilateral framework covering investment, “subject to a decision to be taken by explicit consensus on modalities at the Cancun Ministerial in 2003”. Its purpose was “to secure transparent, stable and predictable conditions for long-term cross border investment” that will expand trade.

Two questions therefore face the international community, and developing countries in particular: Can new multilateral initiatives on investment policy promote more – and more productive – investment and hence more rapid development? And, can a negotiation that includes this area lead to reciprocity that will expand developing countries’ opportunities?

The drive to include an international investment agreement in the WTO accords comes against a backdrop of one of the most impressive waves of foreign direct investment in history. Indeed, a hallmark of globalization has been the expansion of foreign direct investment (FDI). Developing countries have been major beneficiaries, with FDI flows comprising almost three-quarters of net financial flows in 2002. Moreover, FDI flows tend to be more stable and less volatile than portfolio or debt flows. They are bundled with cross-border flows of technology, management expertise, and/or a differentiated product – distinguishing them from other financial flows.

This picture changed abruptly in 1998. Since then, FDI flows have leveled off (figure 1) though they have not fallen as precipitously as debt flows (figure 2). FDI trends were a reflection of several factors: the bursting of the stock market bubble in 2000, which lowered market value of all corporations, and made it less attractive to undertake acquisitions via exchanges of stock, a main driver of intra-OECD investment; the subsequent downturn in the global economy which lowered profitability in markets, and with it the incentive to undertake investment anywhere, particularly in higher risk foreign markets; and the reversal of current account balances in East Asia and Latin America after 1998 that reduced the demand for financing from all foreign sources. Investment in infrastructure—notably power and telecommunications—contracted disproportionately, reflecting overbuilding ahead of growth in demand, so the cessation of growth (particularly in East Asia and Latin America, favored destinations in the early 1990s) left these industries with global excess capacity. By 2001, FDI in infrastructure was down more than 20% relative to 1998 peaks. Finally, the wave of privatizations on attractive terms, crested in the 1990s, dissipated by the turn of the millennium.

Against this backdrop of stagnant FDI flows to developing countries, the aspiration of the Doha declaration to increase stable flows seems noteworthy. An international agreement might contribute to increasing stable flows of investment through two main channels: increasing market access for investors to permit enhanced competition;
and augmenting protection of investors’ rights to reduce risk and thereby raise relative risk-adjusted returns.

Increasing market access for investors

As with trade barriers, countries around the world have progressively dismantled restrictions on incoming foreign investment, as nationalist fears of many governments have given way to aggressive pursuit of foreign investment. Countries as diverse as China, Mexico, and most recently, Korea have progressively lowered policy barriers to entry in sector after sector to bring in new sources of capital, increase competition to spur productivity growth, and accelerate the pace of technological progress. Consider the changes in investment regulations. UNCTAD research has shown that between 1991 and 2001, a total of 1393 regulatory changes were introduced in national FDI regimes, of which 1315 (or 95 percent) were in the direction of creating a more favorable environment for FDI (Figure 3). During 2001 alone, a total of 208 regulatory changes were made by 71 countries, only 14 of which (or 6 percent) were less favorable for foreign investors (UNCTAD, 2002). The vast majority of these changes were introduced autonomously rather than in the context of international negotiations.

Today, nearly all countries have removed entry restrictions and limitations on foreign equity shares in manufacturing. Some restrictions remain in mining, natural resources and agriculture, though these mainly take the form of regulations on land use and concessions. The main restrictions on FDI are centered in services – that is, in finance, telecommunications, power, transport, ports, wholesale and retail trade, real estate, and business and legal services (Hoekman and Saggi, 2000; Sauvé and Wilkie, 2000). In finance, communications, and power, many countries restrict entry to protect state monopolies; in other sectors, powerful unions, professional associations, or business lobbies may prevent entry; and in others, entry is restricted merely as an anachronistic carry-over from a less globalized era.

The payoff to unilateral reductions in these policy barriers to entry is high. Foreign investment in telecommunications, for example, has revolutionized telephony service in developing countries. One study found that reducing protection in services by half would have a benefit to incomes
One pre-requisite for moving forward with a multilateral investment agreement is that participating countries must believe the policy commitment make sense through the lens of promoting national development. While the upside benefit to autonomous liberalization in services (among other areas) is usually high, it may not be for a particular country. Fortunately, the modality under discussion is a GATS-like positive list that would let policymakers set their own pace for liberalization and avoid commitments in any sector where it felt uncomfortable. This provides an unusual degree of flexibility to all governments—even if it slows the pace of multilaterally agreed liberalization.

From the narrow perspective of market access for investors, an international agreement is less urgent. Since most restrictions that limit FDI entry are in services, a multilateral vehicle for realizing the twin benefits from an international agreement already exists for services, namely the General Agreement on Trade in Services (GATS). The agreement allows countries to designate those sectors it wishes to liberalize and maintain entry restrictions in other sectors a government feels are important. In any case, the fact that market access could be widened under the GATS in precisely the area where most restrictions exist limits the additive value of any new investment agreement—save for the reciprocal access it leverages in other sectors.

Including these potential reforms to national investment regimes in a new international investment agreement has two potential benefits that may lead to greater investment. First, much as with the logic of a trade negotiation, the negotiation process may lead to greater liberalization of investment regimes than can be accomplished unilaterally. Second, if investment is not negotiated in isolation, but as part of a broader set of trade negotiations, then the traditional mechanism of reciprocal access concessions can help generate support for greater openness at home and abroad. For example, exporters in developing countries who obtain improved access to foreign agricultural markets can be a countervailing force against those who resist the elimination of investment barriers in telecommunications. At the same time, the need to fight these domestic political economy battles makes a country a credible negotiator for improved access. The process, if it works, can produce a double benefit: liberalizing countries would benefit from increased competition associated with foreign direct investment, and their firms would have improved access to foreign markets.

A key issue—which can only be determined during the negotiation process—is the value of an investment agreement in leveraging reciprocal commitments among trading partners. If an investment agreement is reciprocated with new market access in markets of importance to developing countries—in agriculture, labor-intensive manufacturers and even services—it may produce the much sought-after double benefit (World Bank 2002). From a strictly market access perspective, this underscores the importance of judging the upside

four times larger than liberalization of merchandise trade (Robinson, et al, 1999). The World Bank (2001), using conservative assumptions to illustrate the effects of reforms in trade and transportation, communications, financial services, and other private services, showed that broad and simultaneous services reforms could produce income gains for developing countries of more than 9 percent (World Bank, 2001: 171-172). Realizing this high potential requires more than liberalization—it requires a regulatory framework that, where possible, permits competition and disciplines natural monopolies in network industries; and it requires pro-poor regulation that ensures where appropriate universal access and cross-subsidies to the poor or disadvantaged regions (see World Bank, 2001: pp 77 ff).
potential of a new agreement against the reciprocal access it leverages in other sectors.¹

**Increasing Investor Protections**

A second possible channel to increase investment flows – distinct from wider market access – is through increasing investor protections. A foundation of any country’s investment climate is the protection of property rights for investors. Since investors put money at risk against the promise of returns in subsequent periods, predictable regulation and protection of property rights are integral to the investment decision. Stein and Daud (2002) have shown that institutional variables associated with investor protections – including political stability, government effectiveness, rule of law and lower risks of expropriation – are all significantly associated with increases in investment flows, controlling for other determinants of FDI. Said differently, the policies and institutions that frame the domestic investment climate are a powerful determinant of inward investment flows.

Would protections in an international investment agreement (IIA) lead to increases in foreign direct investment into developing countries? One benefit² might conceivably arise from multilateral investment protections. A multilateral set of disciplines on investment protection would arguably help participating developing countries send a positive signal to potential foreign investors regarding the permanence of policy changes, the expected standard of treatment afforded to foreign investors, and recourse to a dispute settlement procedure. Surprisingly few empirical studies examine whether in fact an IIA will increase investment.

One way to test this proposition is to look at the consequences of enhancing investor protections through bilateral investment treaties (BITs) for flows of FDI among signatory countries. BITs customarily provide a definition of investment coverage, provide investor protections such as against expropriation, require national treatment for post-entry establishments, stipulate compensation for the expropriation of their investments, and provide for a dispute resolution mechanism. The latter usually permit the investor to sue the state for breach of treaty under binding arbitration. In some cases, treaties proscribe any government action that would reduce the value of the private investment, even if based on environmental or other regulations, and establish grounds for compensation. Such compensation could either entail extensive liabilities for the host government or compel them to refrain from making certain policy choices.

Does the signing of bilateral investment treaties increase the flow of FDI? Few studies address this question.³ In the most exhaustive study to date, Hallward-Dreimeier (2002) analyzed bilateral flows of OECD members to 31 developing countries over two decades. Her analysis found that, controlling for a time trend, BITs had virtually no independent effect in increasing FDI to a signatory country from a home country. Said differently, countries signing a BIT were no more likely to receive additional FDI than countries without such a pact. Even comparing flows in the 3 years after a BIT was signed to the 3 years prior, there was no significant increase in FDI.

**Figure 4** However, BITs do not add much

![Graph showing FDI inflows before and after signing BITs](image)

*Note: Share of annual FDI flow Source: World Bank Global Economic Prospects 2003*
This evidence suggests that protections resulting from a multilateral investment agreement will, *by itself*, have little impact in achieving the objective of increasing investment flows. Another line of reasoning supports this conclusion. BITs cover about half of investment to developing countries already, and any new multilateral investment protections are unlikely to be superior—and therefore additive—to these bilateral investment treaties.

It is worth asking whether enhanced investor protections, in combination with reductions in trade protection that permit liberalized investment access and more open flows of goods, would lead to increases in foreign direct investment. The experience of regional agreements is arguably relevant. One example is NAFTA. NAFTA is a comprehensive arrangement that includes significant investor protections in combination with broad-based tariff reductions and border liberalizations. Chapter 11 of the NAFTA agreement allows investors to sue the government in event of regulatory or other actions that might diminish the value of a foreign investment. In their study, Lederman, Maloney and Serven (2003) find that, in addition to positive forces in the global economy that propelled investment into Mexico and other emerging markets after 1994, “the trade opening and NAFTA accession also played a role in Mexico’s FDI rise…” (2003: chapter 4: 23). Firms, especially export oriented firms, appeared to take advantage of liberalized financial flows inherent in NAFTA to begin to use foreign equity and debt financing.

Neither this study nor others attempt to distinguish the role of enhanced investor protections from access to the Mexican market and its other resources in increasing the flow of FDI. It may be that simply liberalizing the investment law in 1993 and making it easier to take advantage of productivity-adjusted wage differentials in the NAFTA countries was sufficient to explain the difference. Indeed, Daude and Stein (2001) find that FTAs generally tend to increase FDI. Lederman, Maloney and Serven (2003) corroborate this when FTAs combine to form the largest markets. However, investor protections in Chapter 11 may have played an important independent role. This is because Mexico’s legal and judicial framework is well below competing destinations (such as East Asia, the US and UK, and even the average for Latin America). In an analysis of shareholder rights, creditor rights, efficiency of judiciary, rule of law and absence of corruption, Mexico scores below the Latin American average in 4 of 5 measures (Lopez de Silanes, 2002, as cited in Lederman, Maloney and Serven 2003:24). To the extent that Chapter 11 provided investors with additional comfort over and above the existing investment climate, its protections would have offset these disadvantages.

In a multilateral context, the aspiration of the Doha round is precisely to combine global reductions in border barriers for goods and services with increases in investor protections. To be sure, the experience of regional arrangements is less relevant to the extent that the preferential trade access diverts investment into the preferential market and/or that trade openness dominate the effects of additional investor protections. Nonetheless, the potential for some, as yet unquantified synergy between more open markets and agreed investment protections exists. Much as with our conclusions above on the anticipated benefits for liberalizing market access, this section leads us to conclude that the benefits to developing countries of a multilateral set of disciplines for investment rest largely on whether the process of negotiations secures commitments for new market access in agriculture and other goods of interest to developing countries.

Dispute resolution merits careful scrutiny

Benefits flowing from a multilateral investment agreement also can entail costs
if a contractual agreement is broken – as it should. It is important that parties to an agreement understand the contractual liabilities they assume when the sign onto commitments. The Working Group on Trade and Investment has reached consensus that, in contrast to the provisions in bilateral investment treaties, individual foreign investors will not be allowed to sue foreign governments for abrogation of protections; rather the home government of the investor would file an appeal under normal WTO dispute resolution procedures.

This distinction is important. The number of cases being filed under the BITs and Chapter 11 of NAFTA is rising rapidly. Forty-eight alleged BIT violations are under review arbitration at the International Center for Dispute Resolution. Cases have arisen out of the Argentine devaluation, changes in tax policy perceived as adverse by investors, expropriations following conflict or coups, irregularities in bidding processes and others (see Peterson, 2003a). Perhaps the most significant case to date is of a tribunal in Stockholm that required the government of the Czech Republic to pay one company, Central European Media (CME), $350 million for violation of a bilateral investment treaty that deprived CME from a stake in an English language TV station in Prague. This amount was ten times higher than previously known awards under arbitration cases, and about equal to the entire public sector deficit of the Czech Republic (see Peterson 2003b). Several separate cases under NAFTA similarly have prompted successful investor suits against all three governments—Canada, US, and Mexico–by investors. Unrelated cases in each of the three countries, for example, contended environmental regulations reduced the value of their companies; arbitration panels awarded hefty damages and raised new complex legal issues.

Since the WTO discussions have adopted a different approach than investor-state suits, their corresponding damages are largely irrelevant. However, they do underscore the importance of the ultimate rights of aggrieved parties that win cases under WTO panels. The WTO could “instruct the offending member to bring the inconsistent measure into conformity with its WTO obligations”; and, failing that, “prevailing states are free to resort to …unilateral counter-measures …suspension of the treaty….and temporary compensation or suspension of concessions” (WTO 2002: 20). What would be the appropriate remedy for a government that imposed a regulation that effectively diminished the future earnings of an enterprise? While these have an established history in the case of trade disputes, there is no comfortable parallel in investment. These issues have received insufficient attention to date.

Conclusion

The benefits of a multilateral investment agreement for developing countries hinge critically on the increased market access such an agreement would leverage for their exporters and on the additional domestic reforms that it leverages at home. If negotiating partners, particularly in OECD countries and in middle income countries that are investors themselves, see a multilateral investment agreement as worthy of concessions that reduce their barriers to trade in agriculture, textiles, and other areas of importance to developing countries, an agreement in this area would be a classic “win-win” for all parties. Evidence suggests that trade liberalization combined with clear investment rules holds the largest potential for increasing investment – and the highest productivity investment – in developing countries. However, an investment agreement without substantial new market access is unlikely to accomplish its objectives of increasing stable investment flows. And there is an important coda: to avoid problems that are now surfacing with the resolution of disputes with bilateral investment treaties and NAFTA’s Chapter 11, it is important that all countries understand the fine print associated with dispute resolution.
Relying on the GATS framework has two drawbacks. First, it would not cover investment outside of services, and, while this is the sector with greatest restrictions, some potential would be foregone. Second and more generally, the GATS has fallen short of its potential. The coverage of commitments for a large number of countries is limited. About two-thirds of the WTO membership has scheduled less than 60 or fewer sectors (of the 160 or so specified in the GATS list) (see Stern, 2002). In many cases, commitments do not reflect the actual degree of openness (Mattoo, 2000). In other cases, countries have not moved actively to register sectors – even where domestic policies are open to foreign investment. Finally, sometimes countries’ commitments serve to protect the position of privileged incumbents, domestic and foreign, rather than to enhance contestability of markets. The primary reason is the incentives to participate in the form of reciprocal benefits within the narrow area of services itself are rather low; Doha may offer an opportunity to redress this problem if rich countries are willing to table significant liberalization in agriculture and textiles in exchange for access to services markets in developing countries.

Another less important argument is that a multilateral regime for investment protection could help to counter-balance the bargaining asymmetries built into BITs and regional agreements conducted along North-South lines. The negotiating asymmetries that are common to bilateral agreements have in some cases led to treaties in which developing countries have taken on substantive obligations with reciprocity effectively limited to the promise of increases in future private investment (see below). Moreover, to the extent the power imbalance is actually redressed in a multilateral agreement in favor of weaker states, constituencies within the global business community may well, as was the case in the MAI negotiations, prefer the stronger level of investment protection embedded in BITs and lose interest in a multilateral agreement.

UNCTAD in a recent study found little evidence that BITs increased FDI (UNCTAD, 1998). That work looked at a single year of investments and tested if the number of BITs signed by the host was correlated with the amount of FDI it received.

They find that: “FTA provisions tend to a host country that is an FTA partner with a source country will receive 70-percent more FDI that a non-partner, other things being equal” (2001: 114), though it should be noted their regression coefficients are significant only at the 15% level.

References


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