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Cancun Agenda: Trade and Investment

The Way Forward for Developing Countries

The Cancun Ministerial Conference of WTO scheduled to be held in September 2003 will be of critical importance for developing countries. Among other issues that will be taken up for discussion at the Conference will be whether or not to launch negotiations on investment. Investment has emerged as the most contentious in the WTO negotiations. At the Fourth Ministerial Conference of WTO at Doha, the finalization of the draft Declaration was held up because differences between the developed and developing countries on investment issue, among others. The Declaration was adopted only following the clarification by the Chairman of the Ministerial Council to the fact that the decision to launch will be taken at the Fifth Ministerial Meeting subject to an explicit consensus on the desirability of the negotiations and not merely on the modalities of negotiations.

The attempt of developed countries to seek a multilateral regime on investment through multilateral trade negotiations is a part of their strategy to secure more favourable conditions for overseas operations of their enterprises that use FDI as a mode of servicing foreign markets more than trade now.

Against that backdrop, this policy brief examines the relevance of a multilateral framework on investment from a developing country perspective in the light of the evidence available on the role of FDI in development. It also suggests the policy options that developing countries may consider at the Cancun Ministerial Conference on the issue of Trade and Investment. It also reflects on the approaches to make different elements of a possible multilateral framework on investment more pro-development and balanced, in case a negotiating mandate is unavoidable at the Cancun.

Developmental Impact of FDI: The Role of Policy Space

FDI usually flows as a bundle of resources including, besides capital, production technology, organizational and managerial skills, marketing know-how, and even market access through the marketing networks of multinational enterprises (MNEs) who undertake FDI. These skills tend to spill over to domestic enterprises in the host country. Therefore, FDI can be expected to contribute to growth more than proportionately as compared to domestic investments in the host country. A body of literature that has analyzed the effect of FDI on growth in inter-country framework and another analyzing knowledge spillovers to domestic enterprises from MNEs reaches mixed findings suggesting that these relationships are not unequivocal. There is also a possibility of MNE entry affecting domestic enterprises adversely given the market power of their proprietary assets.

Therefore, FDI may crowd-out domestic investment and may thus be immiserizing or welfare reducing, as has been revealed by a number of recent studies. The mixed findings on the role of FDI in growth in different countries suggested a role of selective policies and performance requirements that host governments use to influence the quality of FDI inflows. Therefore, policy flexibility is important for developing countries for benefiting from FDI. The studies have also documented the evidence of widespread use of performance requirements and other selective policies by developed countries in different stages of their development (See RIS Discussion Paper #52).

Relevance of a Multilateral Framework on Investment (MFI)

A basic question before entering into any negotiation on an MFI is to determine to what extent there is a need for a new multilateral instrument on investment, and what its costs and benefits for developing country members may be. Against that backdrop, we now make an assessment of the relevance of MFI from a developing country perspective.

There is no Conceptual Justification of a GATT-Type Framework on Investment

There is a conceptual basis for trade liberalization on the principle of comparative advantage where countries

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with different comparative advantages benefit from trading mutually. On the other hand, FDI flows emerge because of differences in the levels of development and bundles of created assets of national enterprises. From the start, therefore, MNE entrants enjoy an edge over local enterprises.

Is WTO a Right Forum for Handling Investment?

FDI, like domestic investment, is a development and industrialization issue rather than a trade issue. That WTO lacks competence to deal with the investment and development is clear from the fact that the Working Group on Trade and Investment, set up as per the Singapore Meeting in 1996, has not been able to complete its work so far. Major differences exist between members on different elements of a possible framework.

One-size-fits-all FDI Policy is not Appropriate for Countries at Different Levels of Development

Countries at different levels of development receive different types of FDI; for instance, an underdeveloped country will attract resource-seeking or labour-seeking inward FDI- and a more developed one-investments in capital and intermediate goods industries. The one-size-fits-all approach to FDI evolved through MFI in WTO cannot serve the best interests of countries at different levels of development.

Policy Space is Needed to maximize the contribution of FDI to Development

Evidence suggests that the host government policies have played an important role in extracting the benefits from FDI in developed and developing countries. A multilateral regime will take away the ability of the host governments' to direct FDI in accordance with their development policy objectives and thus will affect the overall 'quality' of FDI inflows.

MFI is Unlikely to Expand the Magnitude of FDI Inflows

In contrast to the argument of its proponents, an MFI is unlikely to increase FDI inflows. Numerous empirical studies have shown that FDI inflows are largely driven by the gravity factors such as market size, income levels, the extent of urbanization, geographical and cultural proximity with the major source countries of FDI, and the quality of infrastructure. The policy factors or investment treaties play a relatively minor role if at all. The US is the most important source of FDI in China and Brazil even though they do not have even a bilateral investment treaty with the US.

International Framework for Investment Protection and Dispute Settlement Exists

A general impression that is created by the protagonists is that an adequate framework for protection of investment and dispute settlement does not exist. However, there exists an elaborate framework for investment protection and dispute settlement at the bilateral as well as multilateral levels. Besides an extensive network of about 2100 bilateral investment promotion and protection agreements or treaties (BIPAs or BITs), multilateral instruments for protection and guarantee of international investments do exist, viz. the Multilateral Investment Guarantee Agency (MIGA), the International Convention of Settlement of Investment Disputes (ICSID), the UN Committee on International Trade Law (UNCITRAL), and the International Chamber of Commerce (ICC).

A Multilateral Treaty Would Not Substitute the Need for Bilateral Investment Treaties (BITs)

Contrary to the general impression created, the bilateral investment treaties would be needed even with a multilateral agreement just as the presence of GATT in trade in good has not substituted the need for bilateral trade agreements. BITs provide necessary flexibility to partners and are much easier to be concluded. A contrast is the failed OECD's negotiations for MAI.

Asymmetry between Investors' and Host Country's Interests

Proponents of MFI are seeking to protect only the rights of investors or corporations and nothing is being proposed in terms of their obligations or any other provisions for protection of host country interests. MNEs command enormous resources and power granted by their gigantic and global scales of operation that can be misused to pursue restrictive business practices. While the ability of the host governments to impose performance obligations is sought to be curbed, that of corporations to impose restrictive clauses on their subsidiaries that are often trade distorting, is not regulated. An ideal accord would have to have a symmetry between rights and obligations of host as well as home governments and investors.

Asymmetry between Interests of Capital and Labour Exporters

The proposed framework on investment proposes to liberalize capital movements without providing for the labour mobility and hence would create asymmetry. The economic arguments for free movement of labour are no weaker than those for the free movement of capital.

To sum up, therefore, a GATT-type multilateral framework on investment (MFI) is justified on neither conceptual or policy grounds. It could lead to considerable loss of welfare in developing countries by reducing policy space. It does not offer any reciprocity neither more FDI nor labour mobility. In view of this, developing countries resisted a negotiating mandate on investment at the Doha Ministerial Conference held in November 2001.

The Way Forward for the Cancun Ministerial Conference

The Doha Declaration only recognizes a 'case' for but does not establish the 'need' for a multilateral framework. The Chairman's understanding and clarification that enabled the adoption of the Declaration at the Doha Ministerial suggests that the negotiating mandate would itself be subject to an explicit consensus.

In the light of the Doha Mandate, there are four possible options for developing countries as follows.

Most Preferred Option: Resist a Negotiating Mandate at Cancun

Keeping in mind the Chairman's clarification, it is still possible to resist a negotiating mandate on investment. For this to happen the coalition of developing countries would be of critical importance. Developing countries will have to draw attention to the practical problems involved in arriving at a consensus on the subject in the light of the OECD's failed MAI negotiations even among 29 rich countries. The wide variation in the levels of development in the WTO membership would further limit the chances of arriving at a consensus. The potential cost in terms of world development and welfare could be substantial while promise of gains is negligible, if at all. This option would be by far the most desirable and also most challenging. Yet, it is feasible depending upon the effective coalition building. Least Developed Countries and the African Union Countries have also opposed MFI.

A Compromise Solution: A Multilateral Treaty on Investment Negotiated Outside WTO

In case developed countries persist with their demand for MFI, a compromise solution could be a multilateral treaty on investment negotiated outside the Single Undertaking of WTO. The objective of proponents of MFI is 'to secure transparent, stable and predictable conditions' for cross-border investments particularly FDI, that can be well served by a freely standing independent multilateral treaty on investment negotiated within the United Nations framework like many other international treaties such as a the Law of the Sea.

The Last Resort: Negotiating a Development-friendly Multilateral Framework in WTO

In case a negotiating mandate on investment is unavoidable at Cancun Ministerial, then developing countries have to ensure that the Framework covers adequate development provisions so that their process of development is not disrupted and sufficient flexibility to pursue their developmental policy objectives is retained. This will be a big challenge and has to be responded by proactive home-work by the developing country negotiators.

Incorporating a 'Development Dimension' in a Possible MFI

Some considerations for designing a development-friendly framework **negotia**ted within or outside the single undertaking are as follows:

(a) Scope and Definition

Adoption of broad assets-based definition and all encompassing sectoral coverage would limit the governments' ability to regulate financial flows and manage the financial crises. The focus of the Doha Declaration is on 'long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade'. In view of this the scope of MFI could be restricted to FDI especially the export platform FDI that only contribute to expansion of trade. Furthermore, developing countries may wish to limit the scope of MFI to only greenfield investments and not acquisitions in view of the greater potential of the former to contribute to the expansion of trade.

(b) Transparency: A Symmetric Framework

While transparency with respect to FDI policy framework might be unexceptional, some of the procedures for processing and evaluation of proposals might not be made transparent in public interest. Furthermore, governments of developing and least developed countries often experience an information asymmetry in dealing with MNEs with respect to their track record regarding corporate social responsibility, their involvement in bribery and corruption and questionable business practices. Recent cases of Enron, Anderson, Xerox are cases in point. MFI should provide for transparency on the track record of investors by building obligations on the part of home governments.

(c) National Treatment in Post-establishment Phase: Retaining the Policy Flexibility

MNEs are already much ahead of the domestic enterprises in the potential developing host country because of their monopolistic ownership of unique assets, e.g. globally known brand names, Therefore the playing field is already tilted in favour of MNEs. Governments in developing countries often adopt policies supporting 'infant enterprises' or SMEs through some measures favouring them. In view of scarcity of funds, governments may need to limit such incentives to national firms. Discriminatory support measures favouring the domestic enterprises in strategic industries are quite common even in the developed world, e.g. SEMATECH in the US. To protect the flexibility, granting of national treatment in the post-establishment phase may be structured on the basis of a GATS-type positive list approach which is subject to limitations as considered necessary.

d) National Treatment in Pre-establishment Phase: Exclude any Commitments

In view of great variation in the quality of FDI and its possible adverse impact on domestic enterprises, host governments may wish to protect domestic 'infant enterprises' or SMEs through selective policies towards FDI. Host governments may also impose, subject to the TRIMS Agreement, performance requirements on foreign entrants to regulate their operations in tune with their development policy objectives. The Doha Declaration does provide for such flexibility and suggests due regard of development policy and preserves their right to regulate in the public interest. Therefore, developing countries should resist the national treatment obligation for pre-establishment stage to retain the policy flexibility.

The proponents of MFI argue that a GATS-type approach to pre-establishment national treatment commitment allow adequate policy space to developing countries. The experience of GATS suggests that developed countries bring pressure on developing countries to make commitments in the sectors that are of particular interest to them.

(e) Most-Favoured-Nation (MFN): Providing Exceptions for Ethnic Investors

The extension of the MFN treatment to investment may affect the special treatment conferred by many developing countries to "ethnic overseas investors". Exceptions for a differential treatment for ethnic overseas investors may be retained in a possible MFI.

(f) Development Provisions

Developing countries seek FDI as a resource for their industrialization and development. The S&D treatment available to developing countries should include flexibility to impose performance requirements which may require abrogation of TRIMs and provide for balance of payment safeguards, among other provisions.

(g) Balancing the Host Country and Home Country Interests

The Doha Declaration indicates the need for balancing the host and home country interests. However, no indications have been made on the way to balance the interests of developed and developing countries. A balancing of interest between all the stakeholders could be ensured with their rights and obligations and by ensuring a symmetry between capital and labour mobility. Binding obligations should be undertaken by investors regarding transfer of technology, restrictive business practices, consumer protection, environmental protection, disclosure, among other commitments. Home governments should accept an obligation to provide information regarding the involvement of MNEs in any questionable dealings, and cooperate with the host governments in control of RBPs, transfer-pricing manipulation, and in recovery of the liabilities of MNEs resulting from their mis-conduct in host countries.

Developing countries could also seek an International Discipline on Incentives that at present distort the pattern of FDI in favour of developed countries.

(h) Investor Protection and Dispute Settlement

Investor to State disputes should not be acceptable in an MFI negotiated in the WTO framework. Furthermore, there is need to adopt a cautious and restrictive definition of expropriation or 'takings' in the light of evidence on litigations brought by affiliates of US corporations against the Canadian Government under NAFTA seeking compensation for the government regulations. Regulatory actions of host governments for pursuing their development policy goals, environmental and social objectives in broad public interest should be specifically excluded from the scope of expropriation or regulatory takings.

Concluding Remarks

This Policy Brief has reviewed the options open to developing countries on investment at the Cancun Ministerial Conference of WTO which is to decide whether or not to launch negotiations on a multilateral framework on the subject. Given the high opportunity cost of the policy flexibility for the process of development and no reciprocity or gains even in the form of higher inflows of FDI, the most prudent option for developing countries would be to resist a negotiating mandate on investment at Cancun.

A compromise solution could be to negotiate a multilateral treaty on investment on the lines of bilateral treaties outside the WTO. In case a negotiating mandate at the Fifth Meeting is unavoidable, then efforts should be made to ensure that developing countries concerns are built into each element of the proposed framework as outlined.

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