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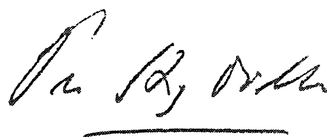

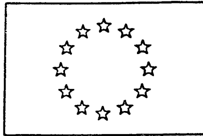

EUROPEAN COMMISSION
Directorate-General for Trade

Directorate D - Co-ordination of WTO and OECD matters. Trade questions relating to GATT, services, dispute settlement, Trade Barriers Regulation
Co-ordination of WTO and OECD matters; GATT

Brussels, 3 April 2003

133 COMMITTEE
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NOTE FOR THE ATTENTION OF THE 133 COMMITTEE

SUBJECT:	**Doha Development Agenda – Trade and Investment EC Concept paper on "Policy Space for Development"**
ORIGIN:	**DG Trade F/2**
OBJECTIVE:	**For information**
REMARKS:	**Final version as sent to the WTO**

Submission by the EC and its Member States to the
Working Group on Trade and Investment

Concept paper on

POLICY SPACE FOR DEVELOPMENT

1. The Doha Declaration states in paragraph 22 that any future investment framework "should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest". This paper addresses some of the concerns expressed in this working group regarding the need of host countries, and in particular of developing countries, to preserve policy space for the purpose of regulating in the public interest and for development purposes.

2. The EC fully supports the view that developing countries should maintain their right and their policy space to pursue their policies and that no international agreement should prevent them from doing so. Following the previous EC paper on the "Impact of international investment rules on current national policies" that we presented in June 2000[1], we would like to deepen the discussion about the right to regulate of host countries and the possible impact that a multilateral "Investment for Development Framework" (IDF) would have on the policies of developing countries in particular. During the last 4 meetings of the Working Group on Trade and Investment (WGTI) some options for investment rules that would allow policy flexibility have been presented and discussed. However, some members still fear that any investment framework would prevent developing countries from pursuing particular policies. We feel that the time has come to try to clarify and substantiate these statements. In particular, it would be useful to start by giving concrete examples of the policies that have been brought forward as impeded by the possible rules that have been proposed in the WGTI by several members. This paper aims at giving a concrete contribution to this debate.

3. In the last part of this paper we also comment briefly on the argument that has been put forward a few times in this group according to which FDI produces a "crowding-out" effect on domestic investment. Although this argument is not directly linked to the negotiation of an IDF, it seems to us that it has been used consistently to imply that an investment framework would increase the supposed negative effect that FDI can produce on host countries. First, we have found no evidence in real life that there is any "crowding-out effect" problem caused by FDI. Second, we do not see how an IDF would amplify any such feared negative effect caused by FDI in host countries.

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[1] Communication from the European Community and its Member States WT/WGTI/84 of 16 June 2000.

I. WOULD A MULTILATERAL FRAMEWORK RESTRICT "POLICY SPACE" FOR DEVELOPMENT ?

4. A few members have often referred[2] to the flexibility (and thus, potential benefits) that bilateral investment agreements provide to their economies as opposed to the believed inflexibility (and implied damages) that multilateral investment rules would impose on their policy space. This striking difference is not corroborated by any evidence, as far as we know. The only explanation given was that in most bilateral investment treaties concluded by these countries "national treatment and MFN treatment were accorded with respect to the post-establishment phase once investments had been admitted in accordance with the applicable policy framework", and that "bilateral investment treaties provided protection of foreign investment and did not deal with market access issues"[3].

5. One could conclude from the above that, according to these members, their policy space would be impeded mainly by pre-establishment rules. This will be the main focus of this paper.

6. We should also ask ourselves: what are host country development objectives ? Are they universal or do they differ from country to country ? Some of them, such as generation of employment and income growth, seem to be universal. We also know that some policies are applied specifically by some countries to develop particular regions, or to protect minority groups, or to promote local small and medium enterprises. Some of these policies are pursued through positive discrimination in favour of these regions, groups or sectors. It has also been argued by some developing countries that mandatory performance requirements imposed on foreign investors are essential policy tools for development.

7. We believe that the intended objectives of these instruments are better achieved through means other than performance requirements[4]. Backward linkages and technology transfer through foreign investment depend mainly on the absorption capacity of the host country. For instance, governments can maximise backward linkages and technology transfers by providing better domestic skills, capabilities, supplier networks and infrastructure[5]. Having said this, the point is whether a multilateral framework would prevent countries from using these instruments or not. In particular, we should analyse whether pre-establishment rules would prevent the use of these policies, in light of the fact that BITs, most of which do not include pre-establishment rules, are regularly concluded by many developing countries.

SOME CONCRETE EXAMPLES

8. Paragraph 22 of the Doha Declaration refers to "pre-establishment commitments based on a GATS-type, positive list approach", among the issues to be addressed by this working group in the period until the next ministerial conference. Thus, assuming that a future multilateral framework would include pre-establishment

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[2] See for instance statements in WT/WGTI/M/8 par. 47-49, and WT/WGTI/M/18, par 74.
[3] ibid.
[4] See EC statement in WT/WGTI/M/19, par.65.
[5] See UNCTAD *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*.

rules based on a GATS-type, positive list approach, would developing countries be prevented from pursuing their general or specific policies ?

9. Under the GATS-type approach, members first decide, for each sector, whether to take commitments or not. If a member decides not to take any commitment in a given sector, it remains free to be as open or as closed to foreign investment as it chooses, at any given time. If it decides to take commitments in a given sector, then the member may include in its schedule of commitments limitations to National Treatment (NT) and Market Access (MA). The limitations to the NT principle and MA can also be included as horizontal commitments, which means that they may apply to all sectors of the economy, and not just to one specific sector. Even after taking commitments, a member may still modify or withdraw any commitment in its schedule, provided it follows certain procedures[6]. Indeed, this may not always be straightforward in practice, but WTO members will be able to draw lessons from the GATS experience. Under this system, each member has to strike its own balance between providing certainty (thus, increasing the possibilities of attracting FDI) and retaining flexibility. The following examples show how certain specific policies can be dealt with under the GATS-type approach.

A. POLICIES AIMED AT INCREASING EMPLOYMENT

10. Employment-generation is an objective that most countries wish to pursue throughout their economy. The different policies adopted by governments to maximise employment generation through investment may vary. UNCTAD lists[7] the following among the policy tools to generate employment: 1) measures to attract FDI in general (improving the regulatory framework; liberalisation; targeted promotion; 2) targeting specific employment-intensive industries or promoting FDI in specific regions through incentives; 3) fiscal incentives linked to employment generation; 4) industrial parks or export processing zones.

11. In addition, the following have been listed as policies to upgrade employment and skills, particularly in developing countries: 1) use of official development assistance to implement training programmes; 2) promotion of public-private training partnerships by granting tax deductions and subsidising training costs.

12. The above policies are generally applied in a non-discriminatory way and do not restrict market access. To the extent that these conditions are fulfilled, these policies would not even need to be listed as limitations to NT and MA in the schedule of commitments of the member that applies them. However, even if a country decided to discriminate in favour of its own domestic enterprises, for instance by providing them with special tax exemptions, it would not be required to remove these advantages under the GATS-type approach. If the country wished to have the possibility to offer such fiscal advantages for its domestic enterprises it could include them as horizontal limitations to NT if they applied to the whole economy, or it could include them as sector-specific limitations to NT if they were limited to specific areas of activity.

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[6] GATS Article XXI.

[7] UNCTAD, *World Investment Report 1999*, p. 278.

B. POLICIES DESIGNED TO GENERATE AND TRANSFER TECHNOLOGY

13. Technology transfer from FDI is maximised when the host country provides local capacity to absorb it. Some countries try to encourage domestic companies to develop indigenous technology by providing them with a protected domestic market in which FDI is restricted or completely prohibited. Others require foreign investors to establish partnerships with local partners through joint ventures, as a condition for their access to the market. Although most countries have realised that these policies do not work[8] and are gradually removing them, some may still wish to maintain these restrictions or conditions to FDI.

14. Would the GATS-style approach prevent them from maintaining these instruments ? No. They could either keep a sector "unbound" from NT or they could include specific limitations on MA such as joint venture requirements or other technology transfer requirements, insofar as they constitute market access restrictions.

15. Market-friendly measures aimed at promoting technology transfer, such as providing incentives for specific high technology industries, if applied in a non-discriminatory manner would not even need to be included as limitations to NT or MA in the schedule of commitments.

C. POLICIES AIMED AT PROTECTING MINORITIES

16. Some governments grant specific advantages to ethnic or linguistic minorities, in terms of preferential treatment such as positive discrimination. Whatever the reasons are for adopting such policies (protection of diversity, cultural heritage, improving social conditions, equal opportunities, etc.), the question is whether they could be maintained or not under a GATS-type approach.

17. The GATS experience clearly shows that these policies could perfectly be included as limitations to NT in any given country's schedule of commitments. Thus, it seems safe to conclude that these policies that address particularly sensitive concerns could also be preserved without interference, in the presence of pre-establishment rules based on a GATS-type approach.

D. OTHER HOST COUNTRY POLICIES

18. A country might wish, for some reason, to completely exclude FDI in certain sensitive sectors. Would the GATS-style approach prevent the host country from doing so ? Again, the answer is no. The GATS shows that a number of developing countries have kept "unbound" some sectors of their economy. This does not necessarily mean that they are completely closed to FDI in those sectors, but simply,

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[8] As demonstrated by empirical research. Cfr. T. H. Moran, *Parental Supervision: The New Paradigm for Foreign Direct Investment and Development*, Institute for International Economics, 2001; S. Urata and H. Kawai, *Intrafirm Technology Transfer by Japanese Manufacturing Firms in Asia*. The role of Foreign Direct Investment in East Asian Economic Development, eds. Takatoshi Ito and Anne O. Krueger, 2000; International Finance Corporation and Foreign Investment Advisory Service, *Foreign Direct Investment: Lessons of Experience, No 5*, World Bank Group, 1997; A. Kokko and M. Blomstrom, *Policies to Encourage Inflows of Technology Through Foreign Multinationals*. World Development 23, no. 3 (March) 1995.

that they remain free to take all the measures they wish on those sectors, whenever they like, even if the measures are not in conformity with NT and MA, subject to MFN and transparency principles.

19. It has been said in this working group that "Developing countries needed to retain the ability to screen and channel foreign investment in accordance with their domestic interests and priorities"[9]. We would like to know from those members that have implied that this ability to screen foreign investment would be impeded by any pre-establishment rule, if the GATS has prevented them from screening foreign investment in the services sectors. In our view the answer is no. One of our examples (D) in the annex shows that it is possible for members to include, in their schedule of commitments, the right to screen the entry of foreign investors.

II. WOULD A MULTILATERAL FRAMEWORK REALLY INCREASE THE "CROWDING-OUT" EFFECT ON DOMESTIC INVESTMENT ?

20. Some members brought into debate a fear that FDI can produce a "crowding-out" effect on domestic investment. Some have argued that, if this is so, an investment framework should not be negotiated since the crowding-out effect would be further enhanced, damaging first and foremost developing countries. We would like to briefly reflect on this assumption.

21. The first question to be asked is: does FDI really "crowd-out" domestic investment ? Supposing it does, is the host country really affected negatively ? We have not seen any compelling evidence supporting this view[10]. In our view, foreign investment would actually displace domestic investment if the two were perfect substitutes. Even in this case, the total output in the host country is likely to remain unchanged. If FDI and domestic investment were complementary, there would be a growth in total investment and output in the host country[11]. FDI would "crowd out" in cases where it outcompeted domestic investments, although the latter could find better investment opportunities in other areas of the economy. Some may still argue, following the "infant industry" argument, that FDI may, in a specific sector, establish all the capacity that can be sustained by the available market, and that this would in consequence crowd out domestic investments, even if these potential investments would also have had over time a potential comparative advantage. Even in this specific case, it is acknowledged that FDI tends to stimulate competition and promote domestic investments.

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[9] See WT/WGTI/M/18, par 74, and 137.

[10] See for instance: UNCTAD *WIR 1999*; OECD, "*Foreign Direct Investment for Development, Maximising Benefits, Minimising Costs*", 2002; Saggi, Kamal. "*Trade, Foreign Direct Investment, and International Technology Transfer.*" World Bank, May 2000; Sharma, Kishor, "*Export Growth in India: Has FDI Played a Role?*", Economic Growth Center at Yale University, July 2000; B. Smarzynska, "*Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages*", World Bank working paper, 2002.

[11] For instance, according to the World Bank working paper "*Trade, Growth, and Poverty*", by D. Dollar and A. Kraay (2001), a one percentage point increase in FDI inflows as a share of GDP would result in a positive effect on average incomes over the course of a decade of around 10 percent.

22. Leaving this aside, what can definitely be observed today is that almost every country in the world is striving to attract FDI and devoting increasing resources to investment promotion. This is also reflected in the Trade Policy Review Mechanism, in which most WTO members are eager to show the openness of their investment regime to FDI. Thus, it is not plausible to conclude that most countries in the world would be wrong in trying to attract FDI as they do not realise that their companies risk being crowded out by foreign investors.

23. Even admitting that FDI crowds-out domestic investment, the second question to be asked is: what would be the impact of a multilateral framework on this ? There are 2 alternative possibilities. Either: 1) a multilateral framework would enhance FDI flows, thus, allegedly increasing the risk of crowding-out domestic investment; or 2) a multilateral framework would not significantly increase FDI flows, hence with no impact on the "crowding-out" effect. What cannot be said is that, at the same time, a multilateral framework will increase the risk of "crowding out" domestic investment but it will not increase FDI flows for developing countries.

24. In any case, one of the merits of the GATS-type approach is that it would allow those members that were willing to take, on a sector-by-sector basis, pre-establishment commitments, allowing the entry of foreign investors and perhaps at risk of "crowding out" their domestic investment, to do so only of they wished. Others, who would prefer not to risk the crowding-out effect in certain sectors or even in the whole economy, could simply keep those sectors or their whole economy "unbound", or, in other words, free from FDI. It would be a choice left to each government. Their policy space would be preserved.

III. Conclusion

25. All countries have legitimate reasons for preserving their right to regulate the activities of domestic and foreign investors. The reasons may be different: development objectives, protection of environment and health standards and other public interests. Some countries may not make any difference in their regulations between domestic and foreign operators while others might wish to differentiate the treatment and conditions in which national and foreign companies operate within their territory.

26. We wish to emphasise that an Investment for Development Framework can and indeed must be shaped in a way not to inhibit any country's policy space for development or, in general its right to regulate. The purpose of this paper is to try to move this fundamental debate towards a more concrete level, rather than continuing an abstract discussion between those who maintain that any investment rule would undermine their policy space and those who reply that this would not be true. We look forward to addressing in an open-minded way any other examples that other members may provide, in order to move this debate forward. In particular we would welcome the possibility of discussing any specific development policy or programme that some countries feel might be threatened by an investment framework.

27. As for the possible "crowding out" effect of FDI on domestic enterprises, we are not persuaded that it would be enhanced by an Investment for Development

Framework. Having said this, we are willing to further discuss and deepen the analysis of the "crowding out" effect and on its possible relation with a future investment framework. This framework, as we see it, should leave each country free to strike its own balance between an appropriate policy space required to pursue national development objectives with an appropriate stable, predictable and transparent FDI framework through which firms are encouraged to operate. This balance can be reflected in each country's schedule of commitments.

Annex

Examples of pre-establishment commitments in a GATS-type approach

The following examples are deliberately extreme and do not necessarily represent realistic scenarios. They have been made only for explanatory reasons.

A. Example of a country that wishes to maintain policies aimed at generating employment in domestic enterprises, in sector A.

Commitments	Limitations on market access	Limitations on national treatment
Horizontal commitments (on all sectors)		
Sector A		*Unbound for all existing subsidies to domestic enterprises, for the purpose of upgrading the level of workers' skills*
Sector B		
Sector C		

B. Example of a country that wishes to maintain measures requiring foreign investors to adopt specific types of legal entities, in sector B.

Commitments	Limitations on market access	Limitations on national treatment
Horizontal commitments (on all sectors)		
Sector A		
Sector B	*Foreign investors can only operate through joint ventures, in which they shall not own more than 50% of the capital.*	
Sector C		

C. Example of a country that wishes to maintain preferences for a specific minority group without extending them to foreign investors, on all sectors

Commitments	Limitations on market access	Limitations on national treatment
Horizontal commitments (on all sectors)		*Unbound for special preferences granted to "special minority" persons or companies.*
Sector A		
Sector B		
Sector C		

D. Example of a country that wishes to maintain its right to screen the entry of foreign investors in sector C

Commitments	Limitations on market access	Limitations on national treatment
Horizontal commitments (on all sectors)		
Sector A		
Sector B		
Sector C	*Prior approval by the State authority is required for the establishment of new companies or the acquisition of existing local companies.*	