Asia-Pacific Economic Cooperation

2004/AEOIS/007

Elements of FTAs/RTAs on Investments and Services

Preferential Trade Agreements, Investment Disciplines and Investment Flows

Submitted by: Bernard Hoekman, Richard Newfarmer,
Maurice Schiff and L. Alan Winters,
World Bank

APEC 2004 Economic Outlook International Symposium
Santiago, Chile
12-13 August 2004

PREFERENTIAL TRADE AGREEMENTS, INVESTMENT DISCIPLINES AND INVESTMENT FLOWS

Bernard Hoekman, Richard Newfarmer, Maurice Schiff and L.Alan Winters[1]

Preliminary Draft: Not for Citation

August 10, 2004

Investment is a key component in economic development and has become one of the main objectives of countries in pursuing regional economic integration. The logic is that larger markets and greater competition following trade liberalization and improved policy credibility will increase the incentives for investment. This in turn will raise incomes both directly by increasing the capital intensity of production and by encouraging technical progress. These arguments apply to investment from all sources, but they are applied particularly frequently to regionalism as a means of attracting FDI. In NAFTA, for example, stimulating foreign direct investment flows is an explicit objective.

Negotiators have also turned their attention to investment-related policies, including those affecting trade in services. The latter is heavily dependent on the ability to establish a presence in a market (invest). Reaching agreements on investment issues at the multilateral level has proven illusive, with the exception of services where investment (commercial presence) is covered as a one of the four modes of supply. This may help explain why investment provisions are now becoming common in bilateral and regional preferential trade agreements. Even before the most recent wave of PTAs, bilateral investment treaties (BITs) designed to spur investment flows had become commonplace. Indeed, BITs are the primary vehicle for international cooperation in this area, with some PTAs explicitly not including investment policy disciplines because of pre-existing BITs—e.g., the 200 Canada-Costa Rica PTA (OECD 2002).

However, in the last five years, PTAs covering investment policies have surged. North-South agreements, notably the PTAs involving the US and of the EU, have been important drivers. Examples involving the US are the FTAA negotiations, recent bilaterals with Central America and Arab countries, and Australia. The EU engagement in this area is even more intensive, with the prospect of over 100 PTA partners being realized in the coming years. Investment is on the agenda of the Economic Partnership Agreements as well as other PTAs, albeit often in the form of parallel investment treaties.

From a development perspective, the extension of PTAs to investment can be beneficial, as can BITs. However, clearly much depends on the content of the rules that are agreed. In theory, international cooperation in this area can help countries that need it improve

[1] World Bank. The views expressed in this paper are personal and should not be attributed to the World Bank. Parts of this paper draw on World Bank (2003) and Schiff and Winters (2003)

the credibility of an open investment regime, may reduce risk premia and help attract investment by lowering perceived probabilities of being confronted with TRIMs or expropriation. It may also be used to enhance overall welfare of signatories by coordinating policies or by reducing negative spillovers from national policies. The latter arise due to tax or incentive competition to attract FDI, often a beggar thy neighbor policy that ultimately primarily benefits multinationals.

But the rules may not be beneficial to all signatories equally. In broad terms, the US strategy, for example, can be characterized as offering access to its large markets for goods in exchange for acceptance of rules that may not be first best for developing country partners. Recent agreements that include language on investment may do little if anything to increase the flow of investment to developing country partners. Indeed, in the case of investor protection and dispute settlement provisions the disciplines that are contained in some agreement may be detrimental.

This paper begins with a brief review of the potential impacts of PTAs on investment, both direct—through specific rules governing investment related policies—and indirectly, through the liberalization of trade flows. We then turn to synoptic a comparison of recent agreements, with a focus on provisions in bilateral US and EU agreements. This is followed by a brief discussion of some of the evidence to date on the investment effects of PTAs. We end with some concluding comments.

1. Potential impact of PTAs and investment-related rules on investment

Perhaps the most frequently mentioned channels through which PTAs may have a positive effect on investment are through the associated increase in the size of regional market due to trade liberalization and accompanying trade rules, new investment rules that relax restrictions on market entry (e.g., for services), through new (stronger) investor protections, and the added credibility of government policies generally.

New trade rules that create a larger internal market create an incentive to invest for members and for third countries. Eliminating barriers to trade within a region (without increasing initial levels of external tariffs) creates an incentive for more investment from within the region and, provided there are no barriers, from outside the region. This occurs because the PTA can create a larger market of potential buyers. Markusen (2004), for example, notes that inward investment to reach the local market may well also include tapping lower cost production sites within the new PTA to serve the wealthier parts.

The larger market can also raise productivity. A larger market allows for economies of scale and scope, for increasing competition among a larger potential size of suppliers, and for taking advantage of differing regional factor prices to drive productivity increases and hence more rapid growth – and the more rapid growth provides a dynamic attraction to intra-bloc and extra bloc investment (Schiff and Winters, 2003).

PTAs may also permit new *market access.* A decision to lift an administrative barrier impeding manufacturing investment or an investment in natural resources can create an opportunity for investors and hence prompt new investment. As most remaining restrictions today – equity ownerships limitation, bans on foreign investment in particular activities -- are not on manufacturing, but rather on services (e.g., broadcasting, telephony and airlines in the United States) and natural resources (e.g., oil in Mexico), insofar as PTAs generate such effects this is mostly going to depend on the services provisions of the agreement.

Granting new *investment protections* may also attract additional investment. In general, the strongest investor protections entail nondiscrimination among all investors, provisions against expropriation, and dispute settlement with eligibility for investor-state suits and independent arbitration. The legal power granted to investors to sue governments under terms of the bilateral or regional agreements is arguably the strongest new protection in the trade agreements. These provisions, though they differ in detail, closely mirror those in bilateral investment treaties, even though they are anchored the trade agreement, with the implicit larger commitment of that treaty behind them.

As argued in World Bank (2000) and Schiff and Winters (2003), North-South PTAs can enhance a Southern country's credibility, but typically only if the PTA is likely to enhance economic performance in its own right and if the large Northern partner is willing to enforce investment-encouraging "club rules". The latter is more likely to be true if the policies on which a developing country wants to gain credibility are specified explicitly in the agreement. In general, sound macroeconomic policies, well-defined property rights, and efficient financial and banking sectors are likely to be far more important in influencing investment and FDI than merely joining a PTA. Regional integration will foster investment only if it is accompanied by good policy overall.

Policy spillovers

Investment-related policies may rationally attempt to shift rents (profits) from source to host countries through measures that effectively tax investors. The opportunity for this is created by the fact that FDI usually occurs in imperfectly competitive markets. Such policies can therefore give rise to spillovers. The same is true for policies that encourage FDI, which may be motivated by various factors, e.g., asymmetric information or a perceived need to offset institutional weaknesses. From an individual country's perspective, incentives to attract FDI may be justified if FDI generates positive externalities. Clearly, both types of policies can provide a basis for international cooperation to reduce the negative spillovers. What follows focuses primarily on incentive policies, as these are most obviously potentially detrimental to developing countries and have also tended not to be covered in PTAs.

FDI 'spillovers' may arise because local firms adopt technologies introduced by the multinational through imitation; workers trained by the multinational transfer information to local firms or start their own firms; and derived demand (both upstream and downstream) by multinationals leads to local provision of services or inputs that are also used by local firms. Although the empirical support for positive spillover effects is ambiguous—see Saggi, 2002—if governments use incentives to attract inward FDI, countries may find themselves in a bidding war. This can be to the detriment of the parties involved if it leads to excessive payment to the investor. International cooperation to ban or discipline the use of fiscal incentives could then be beneficial.

A key issue here is whether fiscal incentives are effective. If not, while they will not distort the global allocation of FDI, the funds expended will simply end up as transfers to multinationals. It is precisely when such incentives fail to attract FDI that developing countries have the most to gain from committing to not using them. If incentives do affect FDI, there may be an efficiency case for competition for FDI, as it may act as an efficient signaling device that improves the global allocation of investment by ensuring that FDI moves to where it has the highest social return.

In practice, locational competition is often driven not by efficiency rationales but by political economy forces. This is the case in particular for efforts by high-income countries to retain or attract FDI that would be more efficiently employed in developing countries. Labor unions and local communities may oppose plant closures and efforts by firms to transplant facilities. It is important therefore to distinguish between competition for FDI between developing countries, which may be efficient, and locational incentives used by industrialized nations, which are much more likely to be inefficient by attracting or retaining industries that otherwise would locate in developing countries.

The foregoing suggests that if incentives are effective in altering location decisions, a case may exist for subsidy freedom, but insofar as they are not or are driven by political economy factors in OECD nations, developing countries have an unambiguous incentive to push for international disciplines on incentive policies (Hoekman and Saggi, 2000). PTAs represent one potential vehicle for doing so.

2. INVESTMENT-RELATED PROVISIONS IN PTAS

Explicit policy towards investment in early PTAs was almost always activist and interventionist, co-opting regional integration into import substitution at a regional level. Such policies almost completely failed. They were superceded by a much more market friendly approach that puts greater emphasis on policies guaranteeing the fair treatment of investment. These guarantees are often embodied in Bilateral Investment Treaties, or, where there are trade and other links, investment chapters in PTAs. They typically preclude certain policies rather than requiring policies to actively encourage investment – but they may play an important facilitating role in investment flows.

Bilateral Investment Treaties

Bilateral Investment Treaties (BITs) are now the primary vehicle for international cooperation on the regulation of investment flows. There are now well over two thousand of them linking countries in all continents and at all levels of development. BITs are generally short agreements that seek to remove barriers and reduce uncertainty. They are reciprocal and typically contain sections dealing with scope of application (e.g. definitions of investment, nationality, etc), the treatment of inward investment, general standards for the treatment of investors once established, and dispute settlement.

Most BITs explicitly defer to domestic law on the admission of investment, so that governments retain almost complete discretion to manage the sectors in which FDI occurs and the shares of ownership that foreigners may hold. On standards of treatment within the host country, virtually all BITs call for fair and equitable treatment, security of ownership, and freedom from unreasonable or discriminatory restrictions on the operation of investments. Nearly all guarantee MFN treatment, i.e. that no foreigner be treated more favorably than are the partner country's residents, although, as with trade, this is subject to exceptions permitting even more favorable treatment of partners in a PTA. Most BITs also specify national treatment, i.e. no less favorable treatment for the partner's residents than for domestic residents and in fact, treatment is often more favorable than for domestic residents (for example, where domestic residents face foreign exchange restrictions, but foreign firms effectively do not). Nearly all BITs contain provisions on the transfer of funds associated with FDI and on expropriation. Agreements with the US often have provisions that restrict the imposition of performance requirements and permit the international mobility of key personnel.

Dispute settlement provisions vary, but usually define arbitration procedures, often based, in recent BITs, on international standards such those of the World Bank Group's International Center for Settlement of Investment Disputes (ICSID). The provisions sometimes provide for private entities to take action against the government of the other.

The Treatment of Investment in Current Regional Arrangements

At the regional level, some treaties are just multi-country extensions of BITs – i.e. freestanding investment agreements. These include, for example, the Agreement on Investment and Free Movement of Arab Capital among Arab Countries (of 1970) and the Colonia Protocol on the Promotion and Reciprocal Protection of Investment within Mercosur (1994). This trend has continued, with "side-BITs" accompanying PTAs (OECD, 2002). However, an increasing number of PTAs have begun to include investment provisions. Thus, for example, the EU, the Andean Pact, LAIA, NAFTA and COMESA all have investment provisions.

The most far-reaching investment provisions are those of the EU, where the objective has been to create a common market with a single market for capital and investment. Restrictions on investment and the movement of people are long-gone and the remaining frictions reside in areas such as difference in taxation, company law etc. An important part of the integration of capital markets in the EU is its common competition policy, which restricts the worst excesses of investment incentives (known as state aids) in the EU.

NAFTA contains a deep and innovative investment chapter, especially considering that it is only a free trade area rather than a customs union. It has become a model for other groups such as the Group of 3 and the non-binding investment principles of APEC. NAFTA provides for national treatment in establishment, mfn treatment on establishment and operation, a ban on new performance requirements and a phase-out of old ones, guarantees of convertibility at market exchange rates of funds for repatriating profits, disinvestments etc., and a ban on expropriations except for public policy reasons on a non-discriminatory basis and with full compensation. This is a far-reaching menu, although the governments have made quite a number of exceptions in the Annex to the investment chapter, including general exceptions on national security grounds as well as sector and country specific exceptions. NAFTA also has extensive dispute settlement provisions, including allowing for investor-State litigation.

Nearly all recent agreements have some coverage of investment in their agreements, often through the inclusion of services-related provisions as well as directly addressing investment policy. However, in many cases, agreements do not provide new market access beyond what countries have already scheduled with the GATS..

Table 1. PTAs covering services and investment: A comparison

Agreements	National and MFN/Treatment Market Access[a]	Rule of Origin (Nonrestrictive)[b]	Scope/ Coverage[c] of services	Negotiating Modality for services	Right to Provide Services w/o establishment[f]	Ratchet Mechanism[g]	Investor-State Dispute Settlement	Intellectual Property
U.S.-Jordan	Yes	Yes	Universal	Negative-list			Yes	
U.S.-Chile	Yes	Yes	Universal	Positive-list	No	No	Yes	TRIPS+
U.S.-Singapore	Yes	Yes	Universal	Negative-list			Yes	TRIPS+
U.S.-Australia								TRIPS+
U.S.-CAFTA								TRIPS+
U.S.-Morocco								TRIPS+
EU-South Africa								
EU-Mexico	Yes	Yes	Universal	Standstill[e]	No	No		
EU-Chile								
NAFTA	Yes	Yes	Universal[d]	Negative-list	Yes	Yes	Yes	Yes
MERCOSUR	Yes	Yes	Universal	Positive-list	No	No	Yes	No
Andean Community	No	Yes	Universal	Positive-list	No	No	No	No
CARICOM	Not specified	Yes	Universal	Negative-list	No	No	Yes	No
Asean	Yes	Yes	Univeral	Positive-list	No	No	Yes	No
SADC	No						No	No
COMESA	Yes						No	No
Japan-Singapore	No	Yes	Universal	Positive-list	No	No		
Canada-Chile	Yes	Yes	Universal	Negative-list	Yes	Yes		
Chile-Mexico	Yes	Yes	Universal	Negative-list	Yes	Yes		

[a] Includes fair and equitable treatment.
[b] Denial benefits only to juridical person that do not conduct "substantial business" in one of the member countries.
[c] Non-discriminatory quantitative restrictions.
[d] All agreements exclude specific services.
[e] + future negotiation of commitments à la GATS
[f] Right of non-establishment, that is required to supply a service
[g] Autonomous liberalization is automatically incorporated into agreement.

Source: Mattoo and Sauve, 2004; te Velde and Fahnbulleh, 2003; Mann and Cosby, 2004; Szepesi, 2004a, 2004b.

US Bilateral Agreements

In the broadest of terms, developing countries seek to exchange access to their services markets and guarantees in many non-trade areas for assured access to US goods markets. Key facets include:

- Services trade to be open save for those excluded in a negative list; notably excluded were labor service providers, except provisional visas for professionals associated with investing firms.
- Investment protections, with provisions for national treatment, non-discrimination in pre-establishment provisions for companies based in each

others markets (though liberal rules of origin indicate foreign subsidiaries located in member countries qualify for eligibility).

The PTAs mark a quantum change in trade law in for investor protections by going beyond bilateral investment treaties (BITs) in providing new measures covering investment. Agreements, especially post-Nafta ones, include broad definitions of coverage, including not only foreign direct investment, but also portfolio flows and even sovereign debt issues (see Mann and Cosby, 2004). The macroeconomic or legal consequences of these broad definitions have not been analyzed and could complicate management of short-term capital flows or even work-outs in events of sovereign debt restructurings.

Second, the PTAs include significant pre-establishment rights to market access subject to a list of exclusions (i.e., negative lists). While these rights are bound, it is not clear that governments have actually had to change their applied policies. The US-Chile PTA does require eventual changes in legislations regulating the provision of insurance services and a few other sectors (USTR, 2004), but these seem to be the exception more than the rule.

Third, all but the Australian PTAs create an investor-state suit provision under which investors can take foreign governments to dispute resolution for violation of the treaty's national treatment, nondiscrimination or expropriation provisions, among others. NAFTA's Chapter 11 and Chile's Chapter 10 are the most widely known mechanisms, but these mechanisms are also contained in the Singapore and CAFTA arrangements as well.

EU bilateral free trade agreements

In addition to market access in merchandise, the EU has focused heavily on services in its bilateral PTAs. The earliest (and weakest) is the South African agreement (1999), and contains only the promise of potential liberalization after discussions to transpire in 2004 and 2005. In the EU-Mexico PTA, several general provisions were included, many ratifying GATS arrangements, as well as specific liberalization commitments in the financial sector. The EU-Chile agreement goes further and in addition includes liberalization of telecommunications and maritime services (Ullrich, 2004).

The EU agreements with Mexico and Chile differ in important respects from the US agreements. The trade provisions are phrased on the basis of a positive list, and implicitly exclude new products. The treatment of *investment* and capital flows in both agreements does not appear to be extensive. For example, the EU-Mexico agreement simply states that the existing restrictions on investment will be progressively eliminated and no new restrictions adopted, without specifying particular sectors or setting a timeline for liberalization. The language in the EU-Chile agreement is even more general, calling for "free movement of capital relating to direct investments made in accordance with the laws of the host country." In both instances, the agreements allow for use of safeguards in the event of monetary or exchange rate difficulties, and, although the time limit is set at 6 months for Mexico and 12 months for Chile, allow for continuation of the safeguard after the time limit through its formal reintroduction.

The treatment of *dispute settlement* is extremely similar across both agreements. In general, the EU has no special provisions pertaining to investment, but these are covered under the general dispute settlement provisions for all matters in the agreements (see Szepesi, 2004a and b). Dispute settlement is covered on a state-to-state level, and is first attempted through consultations with a Joint Committee (Association Committee in the case of Chile) within 30 days of a party's request. If this step of "dispute avoidance" proves unsuccessful, the concerned party can forward its request to an arbitration panel comprised of representatives of both parties. The arbitration panel's decisions are binding, and the panel can also rule on the conformity of any measures undertaken as a result of its decision with the original ruling. Both agreements provide extensive detail on the process of appointing members to the arbitration panel, timelines for the panel's ruling, and compliance with the panel's decisions.

Other Agreements

Virtually all of the other major agreements contain references to *services liberalization*. Most agreements allow for national treatment, post-establishment nondiscriminatory provisions (see table 1). All have a relatively nonrestrictive definition of preferential access; by allowing firms to invest that have substantial business in member countries and can invest through those subsidiaries, the number of potential competitions in the market is enlarged.

Agreements with negative lists have several advantages in terms of market access: it permits automatic liberalization of new service industries; it establishes a stronger floor for liberalization by locking in the status quo; it is more transparency; and it may lead to a more productive internal dialogue with sectoral private interests (Mattoo and Sauve, 2004). Ratchet mechanisms that allow new autonomous liberalization to be incorporated automatically into treaties can only occur through negative lists. However, most of the South-South agreements have not liberalized many sectors and some, like MERCOSUR, have not implemented accords in way anticipated at signing.

Investment provisions have differed as well. South-South PTAs generally have been less ambitious with respect to investor protections. This is true for the right to provide services without establishing local affiliates. It is also true for investor-state dispute settlement. For the most part, only the US and EU bilaterals have established sophisticated mechanisms to deal with disputes on investment. Some agreements provide for investor-state dispute resolution, though these protections are less strong than in the North-South Agreements.

Most PTAs do not do much if anything to discipline the use of investment incentives, the EU being a major exception, as noted above.

3. Do PTAs attract more investment?

Unfortunately there are few empirical studies of the impact of PTAs on investment—most trade blocs are so new that the data are simply not there. Where we do have *ex post* evidence on investment, it tends to suggest mild positive effects, but there seems to be no evidence that this translates into higher economic growth. Firmer evidence is available for FDI, which seems frequently to boom after a PTA is signed. This appears to be driven by inflows of investment from non-member countries; the impact on intra-bloc flows is ambiguous. Firms originally located in a member country receive access to the whole market without relocation and so have less incentive to invest in other members. Firms located in third countries, on the other hand, will have more incentive to locate new production facilities in a member country and service the other members of the bloc through intra-PTA (preferential) exports – so called platform investment. This is particularly likely if there are increasing returns to scale in production, making for "lumpy" investments that are only viable above a certain size. The integrated market may become large enough to bear the fixed costs for the establishment of new foreign affiliates. Thus PTAs might attract more foreign investment (such as for the production of consumer durables) into developing regions as a whole than can fragmented national markets.

Moreover, insofar as the PTA is between a developing and a developed country, a firm located in the developing country can take advantage of cheap inputs while obtaining free access to the large developed economy. This can be a powerful stimulus to investment. Although Mexico has long been used as an export platform to the USA, NAFTA had a profound impact on FDI into Mexico after 1994 from countries outside NAFTA, as it became a way to guarantee market access into its Northern neighbors. About 80 percent of the vehicles produced by US auto manufacturers in Mexico in 1997 were for export, compared with 48 percent in 1994 (USITC, 1997). Following the creation of NAFTA, Japan redirected part of its FDI from the US and Canada toward Mexico. While Japanese investments in the US are geared primarily for the local market (mainly directed towards manufacturing, commerce, and banking and finance), those in Mexico particularly in the automobile industry are intended more for the NAFTA continental market. FDI to Mexico rose sharply following the announcement of NAFTA in 1990: from $4.3 billion in 1993 to $11 billion in 1994, the year NAFTA came into force (Schiff and Winters, 2003).

It has also been widely documented that European integration has made the member countries more attractive to US, Japanese and other third country firms. The creation of the single market in the EU in 1992 had a significant impact on Japanese, Korean and Taiwanese company decisions to establish operations in the union (Motta and Norman, 1996). Total inflows of FDI into the member countries expanded from ECU10 billion in 1984 to ECU63 billion in 1989. The European Commission (1998) finds that the EU's share of worldwide inward FDI flows increased from 28 to 33% over 1982-93

For other PTAs similar evidence exists. In the case of Mercosur: following the signature of the Asuncion Treaty, FDI into Mercosur member countries increased, from $3.5 billion in 1991 to $18 billion in 1996 and $38 billion in 1998. With nearly $11 billion, Brazil surpassed Mexico as the largest FDI recipient in Latin America in 1996 (compared with $1.1 billion in 1991). A qualification to these figures is that one can not know for sure that it was the PTA *per se* rather than better policy in general that boosted FDI. Particularly in the case of Mercosur, the two were more or less contemporary. Note also that all of these examples entailed anticipation of the PTA followed by something of a decline. This strongly suggests that PTAs change the firms' views of the optimal stock of investment in the PTA; thus we observe a big step up of during the adjustment period, but only a small permanent increase in the flow commensurate with maintaining the higher stock. There is no evidence to date that steady-state flows of FDI increase.

Lederman, et al, (2004) found that PTAs that formed large markets attracted FDI, controlling for other factors that influence location, but that small markets had no effect. They also find positive effects for NAFTA, although the flow of FDI, even controlling for privatizations, appears to have surged in the first years but not to have been sustained. Waldkirch's (2001) study, with less complete annual data, found that NAFTA increased FDI substantially, mostly from the US and from Canada, Chudnovsky and Lopez (2001—cited in Levy Yeyati, et al) – found that FDI increased in the MERCOSUR, largely from outside sources, but that it often entered via acquisition, displaced domestic investment, and was tariff-hopping designed to produce for the local market, and hence probably contributed to growth less that it otherwise would have.

Levy Yayati, Stein and Daude (2004) used a gravity model to analyze, among other things, the effects of PTAs on FDI inflows in 13 major agreements, and then apply this to a simulation for the FTAA. They found that PTAs have a strong positive impact on inflows, and that if these average magnitude hold after the signing of an FTAA the results would be substantial increases in flows to FTAA countries. However the distribution is uneven, and countries with larger post-PTA market size, low inflation rates, strong domestic institutions, and open are likely to be the biggest beneficiaries.

To investigate further whether PTA formation can affect FDI flows in a consistent fashion, World Bank (2004) examines the effects of PTA membership and other variables on FDI inflows for a panel of 152 countries over the 1980-2002 period. The analysis is not without problems, but does produce rather robust results.[2] The dependent variable is FDI inflow by country measured in current US dollars, and the independent variables include host country GDP and per capita income, trade-to-GDP ratio (openness), GDP growth, annual rate of inflation (CPI), world FDI, world growth, the combined GDP of the country's PTA partners, and year and country fixed effects. The sample takes into account 238 PTAs (both regional and bilateral), many of which overlap and which encompass the vast majority of sample countries. The model was estimated in natural logarithms for FDI, GDP, GNI per capita, world FDI, world growth, and PTA GDP, and

---

[2] Some of the problems include the absence of data on implementation, and the variable coverage of FDI provisions across agreements that makes it difficult to distinguish the effects of investment rules from trade rules. Moreover, the absence on FDI data that would enable us to distinguish the effects of PTAs on differing type of investment – vertical or horizontal – limits the analysis. Nonetheless, the regressions are robust to variations in specifications.

in levels for the other variables. In general, countries that are more open (measured as the sum of exports and imports over GDP), growing more rapidly, and are more stable (captured in less volatile inflation rates) attract greater quantities of FDI, controlling for growth rates of FDI to all countries and the world growth rate.[3]

PTAs that result in larger markets do attract greater FDI. The interaction of a PTA signing and additional market size associated with the integrated markets is significant and positively related to FDI. On average, a 1% increase in market size associated with a PTA produces an increase of 0.5 percent.[4] This has important policy implementations: If a country seeks to use a PTA to attract investment, it should seek to amalgamate with the largest possible markets; PTAs among small market countries have little effect.

Two important caveats to this conclusion are worth underscoring: First, a preferential trading arrangement cannot substitute for an inadequate investment climate. Stein and Daud (2002) have shown that institutional variables that make up the whole of a country's investment climate – 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. These wash out the otherwise positive effects of PTAs. If the economy suffers from poor macroeconomic management, high levels of corruption, and poor infrastructure, a PTA by itself will not

[3] The regression with fixed effects estimation of net FDI inflows is:

lfdi	Coef.	Std. Err.	t	P>|t|
lgdp	.9404982	.2065772	4.55	0.000
lgnppc	-.1228465	.2008249	-0.61	0.541
open	.0051226	.0011387	4.50	0.000
growth	.0198651	.0040816	4.87	0.000
cpi	-.0196485	.0060906	-3.23	0.001
lfdiwld	.4472645	.0719058	6.22	0.000
growld	-.0611576	.0432152	-1.42	0.157
lftagdp	.0518633	.0163279	3.18	0.002

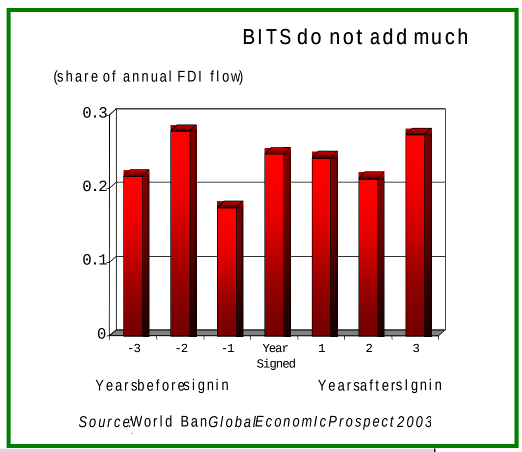
R-sq: within = 0.3973 corr(u_i, Xb) = -0.0410
between = 0.7469 F(28,2003) = 47.16
overall = 0.6690 Prob > F = 0.0000
F test that all u_i=0: F(143, 2003) = 12.79 Prob > F = 0.0000

[4] As mentioned earlier, this variable contains the sum of the host country's PTA partners GDP, excluding the host country itself. Thus, if we consider Brazil as the host country and MERCOSUR as the relevant PTA, the variable lftagdp would be the log of the sum of GDP of Argentina, Paraguay, and Uruguay. This variable serves a twofold purpose in the estimation routine. First, since it is equal to zero prior to signing a PTA and carries a positive value afterwards, it measures whether signing an agreement has an effect on FDI inflows (i.e. including a dummy variable for PTA membership would be counterproductive in the presence of this variable, since it will capture the "threshold effect" of signing a PTA). Furthermore, this variable also captures the effects of participating in a larger market following the signing of an agreement. This is particularly important if a country is party to more than one agreement—the variable will then be a sum of all of its partners' GDP, reflecting the fact that the country has now created a larger market. The fact that this variable is positive and significant shows not only that signing a PTA will generally bring benefits in terms of greater FDI inflows, but also that larger market size of the country's partners tends to generate more incoming FDI.

offset these disadvantages. To be sure it may have help governments through their collective action to improve the investment climate and eventually lead to more investment; but a PTA cannot substitute for an adequate investment climate. Second, creation of a PTA will not have much effect on investment inflows from outside the region if restrictions on market access are severe and remain unchanged.

What about investor protections? Here theory would also suggest that sound property rights are a foundation of any country's investment climate, and, other things equal, stronger rights would lower risk and entice more investment at the margin. 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. However, the evidence for many of the same protections contained in BITs is that these additional protections have no significant effects on inflows of FDI (see Box 1). While a PTA with new investor protections may enhance the credibility of a reform program, evidence that these have observable consequences is scarce.

Box 1 Two Lessons from Bilateral Investment Treaties: Limited Benefits and Potentially High Costs



Does increasing investor protections produce the benefit of higher investment? One test of this proposition was performed by Hallward-Dreimeier (2002). She studies the enhanced investor protections through BITs on flows of FDI among signatory countries.[5] Analyzing bilateral flows of OECD members to 31 developing countries over two decades, she found that, controlling for a time trend and other factors, BITs had virtually no independent effect in increasing FDI to a signatory country from a home country. Put 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. This supports the findings of UNCTAD (1998) that the number of BITs signed by the host was uncorrelated with the amount of FDI it received. Similarly, in a more recent empirical study of PTAs, Dee and Gali (2004) find that whether investment treaties are signed or enacted between countries has no statistically significant effect on outward investment flows.

While the benefits of BIT-type protections in the form of new FDI inflows are open to question, the costs of stronger protection in the form of investor suits can be nontrivial. This is a growing phenomenon. In NAFTA for example, there were 28 cases brought in the first 10 years, 9 each against the US and Canada and 10 against Mexico. In losing 2

[5] 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 it were 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.

of these cases, Canada paid out C$27 million and Mexico US$18.2 million (te Velde and Fahnbulleh, 2003). Under BITs with investor-State dispute provisions, 48 alleged 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 (Peterson, 2003a). In perhaps the most significant case to date, a tribunal in Stockholm required the government of the Czech Republic to pay one company, Central European Media (CME), $350 million for violation of a BIT 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 (Peterson 2003b). The number of cases is rising rapidly.

4. HARNESSING THE POTENTIAL BENEFITS—MOSTLY A SERVICES AGENDA

As argued above, benefits of addressing investment-related policies would be greatest the agenda were to be extended to (fiscal) incentives for investment, in particular FDI. In addition, given that the great bulk of remaining investment restrictions are in services this is probably the area where PTA based liberalization can have the largest direct beneficial impact on investment flows. Services investment is market-seeking, i.e., horizontal investments. These cover a vast range of large multinationals: Deutsche Bank, Wal-Mart, Starbucks, Microsoft, etc. These "mode 3" services trade require the commercial presence of affiliates, branches, or franchises to deliver the service. To be sure, some countries have experienced substantial flows associated with call centers and data processing, such as India. However, new investment also accompanies these cross-border supply ("mode 1") activities.

Barriers to entry into services markets usually take the form of regulatory restrictions on entry, foreign equity limitations, quotas on outputs and foreign service workers, and requirements on legal form of establishment. None of these generate revenue for the government, and so, unlike reducing tariffs, removing these restrictions produce no losses. Preferences, if these are granted, could lead to a higher cost firm gaining competitive advantage vis a vis investors from outside the region, and because of first mover advantages and barriers to entry make it difficult for lower cost suppliers from third countries to enter the market. The extent to which such discriminatory policies would be applied is unknown. In many situations the types of regulatory reforms that are needed should and often will be applied on an MFN basis. As discussed below, the rules of origin that are included in PTAs for services (and other) investors will identify the extent which intentions are discriminatory or not.

Rules of origin for services, as with merchandise trade, play a significant role in determining the degree to which PTAs may discriminate against non-members. For example, if one participant has a fully liberalized market, the adoption of a liberal rule of origin by the other PTA participants can be likened to MFN liberalization. This is because service suppliers can enter in the liberal jurisdiction and then to the other partner countries. Many governments take the liberal rules of origin one step further and subsequently extend regional preferences on an MFN basis under the GATS. This widens the number of competitors in the market and offers greater opportunities of securing access to the most efficient suppliers, particularly of infrastructure services that are likely to exert significant effects on economy-wide performance.

Nonetheless, restrictive rules of origin can limit the potential benefit to liberalization. Participants who seek to benefit from preferential access to a protected market and deny benefits to third country competitors are likely to argue for the adoption of restrictive rules of origin, based on criteria such as ownership or control considerations. This could be the attitude, in particular, of regionally dominant but non-globally competitive service providers towards third-country competition within a regionally integrating area. Examples of restrictive rules of origin for services and investment can be found in MERCOSUR and the Andean Pact. Both limit benefits to juridical persons that are owned and controlled by natural persons of a member country. The experience of the Mexican banking market in the decade following the NAFTA suggests that the adoption of a liberal rule of origin played an important role in mitigating any strong preferences that US and Canadian owned banks received from Mexico under NAFTA (see Box 2).

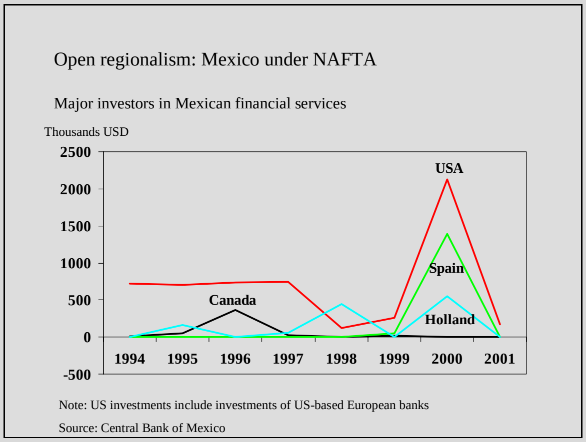
Unfortunately to date, the actual additional liberalization has not matched this promise. Hoekman (2000) argues that with the exception of the EU, most PTAs do not go much beyond the GATS. Indeed, in the case of telecommunications and financial services, the GATS has in fact achieved a higher level of bound liberalization than that on offer in most PTAs (Mattoo, 2002). Of course, multilateral, explicit MFN based liberalization is likely to produce *even larger* gains than preferential regional agreements. This is because multilateral liberalization opens the market to the largest number of competitors and permits consumers maximum choice. It also leads to a less complex policy regime than a preferential arrangement and therefore implies lower administration costs for government agencies and lower transactions costs for the private sector. It remains to seen whether the ongoing round of WTO talks will deliver significantly more services commitments by WTO members or whether governments will instead put greater emphasis on using PTAs.

Box 2 Rules of Origin Shape Competition: the Case of Foreign Banks in Mexico

Prior to NAFTA, Mexico's financial markets were all but closed to foreign competition. With NAFTA, Mexico extended market access preferences to US- and Canadian-based banks. In defining a US- or Canadian based bank, Mexico chose a wide test: nationality was determined by country of incorporation, provided it conducted substantial business operations in that country. Thus, even European or Asian banks based in the US could set up wholly- owned subsidiaries in Mexico under NAFTA. In 2000, Mexico concluded the EU-Mexico FTA, which extended the right to establish fully-owned and controlled financial affiliates in Mexico to European based banks. The degree of liberalization between the EU and Mexico became almost equivalent to the degree of liberalization achieved between Mexico and its NAFTA partners.

The Figure below suggests that between 1994 and 2000 much of the FDI into Mexican banking came from the US. However, the liberal rule of origin meant that European banks *based* in the US were able to access the Mexican market as well. For example, in 1994, Spain's Banco Santander established a financial group in Mexico as a subsidiary of it's US subsidiary in Puerto Rico, using the NAFTA benefits. Once established, in 1997, Santander acquired Invermexico, and formed Grupo Financiero Santander Mexicano. Further, in 2000, Santander acquired Banco Serfin and formed Grupo Financiero Santander-Serfin. In the second half of 2001, after the EU-Mexico free trade agreement entered into effect, Grupo Financiero

Santander Serfin's ownership was transferred from the American (Puerto Rican) subsidiary to Banco Santander Central Hispano of Spain.



Similarly, ING Barings (Mexico) was established in November 1995 as a subsidiary of the American subsidiary of ING Bank NV (Netherlands). However, in 2001, after the entry into force of the EU-Mexico PTA, ownership of ING Barings (Mexico) was transferred from ING Barings (USA) to ING Bank NV (Netherlands) as it was more efficient from a tax standpoint to be directly owned by the parent rather than by a holding company in a third jurisdiction.

Source: Mattoo and Fink (2002).

5. CONCLUDING REMARKS

Agreements differ markedly in their treatment – and implementation -- of investment-related provisions. Results have ranged from mixed to a missed opportunity. In general, the US PTAs have prompted additional services market opening in Morocco, CAFTA and Bahrain, some changes in Singapore, but few changes in Chile and Australia. To be sure, investors may place value on enhanced credibility through lock-in effects. In the South, agreements that have seriously improved services access have been limited – and those that have often have the most limiting rules of origin in investor nationality. More common is the lack of progress.

At the same time, the bilateral PTAs have strengthened investment policy rules, with unclear development benefits for developing country partners. While market access in formally restricted industries are important, the new investor protections provide uncertain benefits in terms of new investment flows. Not only is the promise of greater investment flows or more technology as a development vehicle potentially hollow, but the downside risks of misjudgments in terms of adverse legal and economic ramifications are nontrivial, especially for unsophisticated governments. International treaty law in these areas is evolving fast, and being set through case law of arbitration panels, whose judgments at time conflict (see Ewing-Chow, 2004). Governments may find themselves hauled before arbitration panels and compelled to pay large amounts of compensation for enacting regulations they had considered in their sovereign domain.

We summarized above the empirical evidence on the effect of BITs/PTAs on investment flows. This clearly reveals there are effects for some agreements, especially North-North and North-South PTAs. However, these effects do not appear to a function of investment provisions per se, they are instead driven by a mix of market access/integration and complementary policy actions relating to the investment climate more generally that may be implemented in conjunction with the PTA.

Another way of assessing the likely impact of PTAs is to ask to what extent they go beyond the GATS in elimination of discrimination in service markets. Given that most remaining restrictions are in services, this is an appropriate test to impose. As mentioned, to date PTAs do not appear to do very more than what is in the GATS. Moreover, most PTAs also do little to effectively constrain the ability of governments to provide incentives for FDI—the EU being an exception. In conjunction with the empirical findings that the marginal effects of BIT-type commitments are negligible, and considering the potential downsides in terms of the "ownership" cum political acceptability agreements that include investor-State dispute settlement mechanisms that generate ever higher and frequent awards against governments, it would appear that there is only limited positive value added associated with the large scale administrative investments that have been and are being made to negotiate investment disciplines in or in parallel to PTAs.

REFERENCES

Dee, P. and J. Gali (forthcoming) 'The trade and investment effects of preferential trading arrangements', in *NBER East Asian Seminar in Economics 14 Proceedings*, University of Chicago Press.

European Commission (1998) *Foreign Direct Investment: The Single Market Review*, Vol IV, No. 1.

Ewing-Chow, Michael. 2004. "Investor Protection in Free Trade Agreements: Lessons from North America." *Singapore Journal of International and Comparative Law* 748.

Hallward-Driemeier, Mary. 2003. "Do Bilateral Investment Treaties Attract Foreign Direct Investment? Only a Bit … and They Could Bite." World Bank Policy Research Working Paper 3121.

Hoekman, Bernard. 2000. "Towards a More Balanced and Comprehensive Services Agreement," in Jeffrey Schott (ed.), *The WTO After Seattle*. Washington DC: Institute for International Economics.

Hoekman, Bernard and Kamal Saggi. 2000. "Assessing the Case for Extending WTO Disciplines on Investment Related Policies," *Journal of Economic Integration*, vol. 15 (December), pp. 588-610

Lederman, Daniel, William Maloney, and Luis Serven. 2003. *Lessons from NAFTA for Latin American and Caribbean Countries: A Summary of Research Findings*. World Bank, Washington, DC.

Levy Yeyati, Eduardo, Ernesto Stein, and Christian Daude. 2004. "The FTAA and the Location of FDI." Paper from Central Bank of Chile and World Bank Conference on The Future of Trade Liberalization in the Americas, March 22-23, Santiago, Chile.

Mattoo, Aaditya. 2002. 'Services in a Development Round' World Bank, mimeo.

Mattoo, A. and C. Fink. 2002. [..]

Motta, Massimo and George Norman. 1996. "Does Economic Integration Cause Foreign Direct Investment?" *International Economic Review* 37 (4), November: 757-83.

Newfarmer, Richard. 2001. “Foreign Direct Investment: Policies and Institutions for Growth.” In *New Horizons for Foreign Direct Investment*. Paris: OECD.

Peterson, Luke. 2003a. “Emerging Bilateral Investment Treaty Arbitration and Sustainable Development” Research Note, *Invest-SD News Bulletin*, International Institute for Sustainable Development (IISD). April. (Available at: http://www.iisd.org/pdf/2003/trade_bits_disputes.pdf)

Petersen, Luke. 2004b. “Czech Republic Hit With Massive Compensation Bill in Investment Treaty Dispute” *Invest-SD News Bulletin*, International Institute for Sustainable Development (IISD). March 21

Schiff, Maurice and L. Alan Winters. 2003. *Regionalism and Development* Oxford and World Bank.

Stein, Ernesto, and Christian Daude. 2001. “Institutions, Integration, and the Location of Foreign Direct Investment.” In *New Horizons for Foreign Direct Investment*. Paris: OECD.

Te Velde, Dirk, and Miatta Fahnbulleh. 2003. “Investment-Related Provisions in Regional Trade Arrangements.” London, Department for International Development.

Ullrich, Heidi. 2004. “Comparing EU Free Trade Agreements: Services.” *ECDPM In Brief*, forthcoming.

UNCTAD. 1998. *Bilateral Investment Treaties in the Mid-1990s*, United Nations, New York and Geneva.

United States Trade Representative (USTR). 2004. USA – Chile Free Trade Agreement.

USITC. 1997. The Impact of the North American Free Trade Agreement on the U.S. Economy and Industries: A Three-Year Review, U.S. International Trade Commission, Publication 3045, Washington, D.C.

Waldkirch,, A. 2001. “The ‘New Regionalism’ and Foreign Direct Investment: The Case of Mexico.” Oregon State University Working Paper.

World Bank. 2000. *Trade Blocs*. Policy Research Report. Washington, D.C.

WTO Secretariat. 1995. *Regionalism and the World Trading System*. Geneva, WTO.