UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# PRESERVING FLEXIBILITY IN IIAs: THE USE OF RESERVATIONS

## UNCTAD Series on International Investment Policies for Development

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## PREFACE

The secretariat of the United Nations Conference on Trade and Development (UNCTAD) is implementing a programme on international investment arrangements. It seeks to help developing countries to participate as effectively as possible in international investment rule-making. The programme embraces policy research and development, including the preparation of a series of issues papers; human resources capacity-building and institution-building, including national seminars, regional symposia, and training courses; and support to intergovernmental consensus-building.

This paper is part of a new *Series on International Investment Policies for Development*. It builds on, and expands, UNCTAD's *Series on Issues in International Investment Agreements*. Like the previous one, this new series is addressed to Government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers.

The *Series* seeks to provide a balanced analysis of issues that may arise in the context of international approaches to investment rule-making and their impact on development. Its purpose is to contribute to a better understanding of difficult technical issues and their interaction, and of innovative ideas that could contribute to an increase in the development dimension of international investment agreements.

The *Series* is produced by a team led by James Zhan. The members of the team include Victoria Aranda, Anna Joubin-Bret, Hamed El-Kady, Joachim Karl, Martín Molinuevo and Jörg Weber. Members of the Review Committee are Mark Koulen, Peter Muchlinski, Antonio Parra, Patrick Robinson, Pierre Sauvé,

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Secretary General of UNCTAD

Geneva, June 2006

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## LIST OF ABBREVIATIONS

| | |
|---|---|
| BIT | Bilateral investment treaty |
| EC | European Community |
| EIA | Economic integration agreement |
| EU | European Union |
| FDI | Foreign direct investment |
| FIPA | Foreign investment protection agreements (Canada) |
| FTA | Free trade agreement |
| G-3 | Group of Three (Colombia, Mexico, Venezuela) |
| GATS | General Agreement on Trade in Services |
| IIA | International investment agreement |
| MA | Market access |
| MAI | Multilateral Agreement on Investment |
| Mercosur | Mercado Común del Sur (Argentina, Brazil, Paraguay, Uruguay) |
| MFN | Most favoured nation |
| NAFTA | North American Free Trade Agreement (Canada, Mexico, United States) |
| OECD | Organisation for Economic Co-operation and Development |
| RTA | Regional trade agreement |
| SCM | WTO Agreement on Subsidies and Countervailing Measures |
| TNC | Transnational corporation |
| TRIMs | WTO Agreement on Trade-Related Investment Measures |
| WTO | World Trade Organization |

## EXECUTIVE SUMMARY

Reservations in international investment agreements (IIAs) are a key technique for balancing flexibility of national authorities with international obligations in the field of investment, especially for developing countries.[1] This paper studies the use of such reservations at two levels. First, it assesses the various means that IIA contracting parties have at their disposal when attempting to preserve flexibility and regulatory autonomy, be it for sectors deemed important from a longer-term developmental perspective or for sectors where particular regulatory or policy sensitivities arise. Second, it explores the revealed preferences for flexibility emerging from the reservation lists of eight IIAs employing a negative list approach to scheduling non-conforming measures.

IIAs differ in the way they allow contracting parties to schedule reservations. Two key approaches are found in IIAs. On the one hand, there is the GATS-type approach, which is essentially based on a positive listing in those sectors where countries voluntarily agree to undertake liberalisation commitments. On the other hand, there is the negative list approach which deems all substantive treaty obligations to apply in full unless countries specifically lodge a reservation destined to preserve the non-conformity of existing regulatory measures (or to identify those future measures and sectors in which future regulatory discretion is to be retained).

The study's chapter I devotes particular attention to some of the policy implications flowing from the pursuit of a negative list approach in IIAs. The study also highlights some of the potential downsides of this technique. One is the administrative burden imposed upon weak and resource-constrained administrations in developing countries. Another is that the negative list approach implies full liberalization of all future regulatory regimes – even in sectors that do not currently exist. This latter implication is one to which IIA contracting parties, and particularly developing countries, need to pay attention. For this

reason, the study explores the idea of recording restrictive measures concerning foreign direct investment (FDI) through the implementation of non-binding lists of reservations on IIAs. This would allow for a greater policy flexibility and transparency. The study then analyses aggregate reservations lists as proxies of policy preferences and sectoral sensitivities.

The analysis shows that the overwhelming share of investment restrictions relate to service sector activities, a small part to horizontal measures[2] and primary sector activity, and only a marginal number to FDI in manufacturing. The study finds that almost 3 out of 4 investment barriers reserved in the sample IIAs relate to FDI in services. Developing countries covered by the sample IIAs have shown a greater overall tendency to lodge reservations and to preserve non-conforming measures than is the case of developed countries. However, the sectors in which such reservations are maintained are broadly similar across development levels. Moreover, countries at all development levels broadly resort to the same types of non-conforming measures, with limitations on national treatment destined to tilt competitive conditions in favour of domestic investors and MFN exceptions, aimed at preserving the preferential or reciprocal nature of various agreements, emerging as the most common types of non-conforming measures found in reservation lists.

This study's findings reveal that many countries, independent of their level of development, feel the need to preserve certain economic activities from international obligations. This trend is more pronounced in the case of developing countries, given their need to face greater social and economic problems while also addressing new regulatory challenges with more limited resources and expertise. The challenge for developing countries remains that of finding the proper balance between maximizing the gains from investment agreements and the additional FDI

inflows they can help to induce while also preserving the flexibility to ensure that the benefits of FDI are maximized.

## Notes

[1] It should be noted that a number of the sample agreements contained in this study uses the term "reservation", while others prefer the term "exception". In both cases, these "reservations" or "exceptions" are meant to exclude certain non-conforming measures of the parties from the scope of application of specific treaty obligations. For the sake of consistency, the current study utilizes the terms "reservations" and "exceptions" interchangeably. According to the Vienna Convention on the Law of the Treaties (art. 2.1.d) "reservation" is taken to mean a "unilateral statement, however phrased or named, made by a State, when signing, ratifying, accepting, approving or acceding to a treaty, whereby it purports to exclude or to modify the legal effect of certain provisions of the treaty in their application to that State".

[2] These are measures that apply across the board to all sectors.

# INTRODUCTION

## A. FLEXIBILITY IN INVESTMENT AGREEMENTS: BACKGROUND

Countries enter into international investment agreements (IIAs) with a view to enhancing their investment climate, attracting more and better quality foreign direct investment (FDI) and benefiting from capital inflows. IIAs can offer a series of benefits in this regard, not least by helping to promote a stable, predictable and transparent enabling framework for investment. However, realizing these potential benefits remains a challenge and host countries need to strike a delicate and complex balance between using IIAs for attracting FDI on the one hand, and preserving the flexibility needed for the pursuit of national development objectives on the other hand.

Investment policy is *one* component of a country's overall development strategy, interacting with a host of economic, social, environmental and other policies in pursuit of a better, more balanced and sustainable allocation of resources. Attracting FDI can have a positive impact on a country's development process if investment inflows are properly managed to that end. Such management implies a capacity to pursue and implement policies aimed at ensuring that FDI brings benefits and positive spillovers, preferably to all segments of society, including the poor and marginalized. It also requires capacity to implement policies that aim at keeping potential negative implications to a minimum – bearing in mind the long-term needs of societies and the ecosystems they inhabit.

At the national level, the regulation of FDI may take many forms. Host countries may adopt policies regulating the admission, establishment and treatment of foreign investors and their investments. Other relevant policies are those in fields such as taxation, company, labour, environmental and competition law, as well as sector-specific industrial policies. Many developing

countries, however, do not yet have fully-fledged regulatory regimes and institutions in place. More often than not, national regulatory frameworks are still evolving, with domestic agencies struggling to establish regulatory independence. This may involve a process of trial and error, with regulators seeking to identify those specific policy options that best suit their countries' developmental objectives and their unique contexts. It is, therefore, key that national regulators enjoy the necessary flexibility to do so.

It is in the very nature of international agreements to constrain policy options at the national level. In the case of IIAs, the obligations they establish limit the choices available to policy makers in designing national investment policies. This may be the case, for instance, with respect to performance requirements (such as technology transfer or local content requirements), market access conditions[1] for foreign investors in sensitive sectors or industries, or preferential treatment of established domestic enterprises. While enhancing host countries' investment climates, it is important that IIAs do not unduly constrain the degree of flexibility afforded to national policy makers in the pursuit of development or other national policy objectives. In fact, the importance of national policy space in the investment context was recently re-affirmed in the São Paulo Consensus, adopted at the UNCTAD XI Conference.[2]

IIAs have long recognized – albeit in varying degrees – the need to preserve flexibility for national development policies. Such recognition can often be found in the preamble of an agreement. In addition, it can manifest itself in a more direct operational manner, for example in an agreement's substantive obligations and operating modalities, as well as in the overall degree of flexibility an agreement affords to its contracting parties. Among the key means through which IIAs grant flexibility are

their basic principles and objectives, their design and overall structure, their content and obligations as well as their implementation methods (UNCTAD 2000).

In the context of preserving flexibility, two dimensions of IIAs deserve particular mention. By determining the *nature* and *scope* of the obligations undertaken, these two factors also establish the degree of flexibility – or severity – that each country receives from the agreement. The first dimension relates to an IIA's core substantive obligations, which set the broad parameters of what is and what is not allowed under an agreement. The second, and equally important dimension, relates to the liberalization commitments which contracting parties schedule under an agreement. More broadly, this second dimension also encompasses the nature, level and sectoral incidence of reservations that typically qualify and limit such commitments. Thus, while the main provisions in the text of the agreement determine the overall obligations (and rights) that the contracting parties will have to conform to, the specific commitments and reservations determine the ultimate scope of application of these obligations to the individual sectors and/or industries. Accordingly, only those sectors in which a host country undertakes obligations (under a positive list agreement) or in which it has not lodged a reservation (under a negative list agreement) are subject to the provisions of the agreement in question. Therefore, the lodging of reservations is indeed one of the central means of preserving flexibility under an IIA.[3]

In addition, IIAs may provide for cross-sectoral, general exceptions, for instance for national security reasons or to protect public health, public order or the environment. These exceptions give contracting parties considerable flexibility. Nonetheless, they are left out of this study because of their general nature. An analysis of these exceptions could therefore not contribute to one

of the main objectives of this study, namely to examine as to what extent countries see a need to preserve flexibility with regard to individual economic sectors or individual treaty obligations.

The degree to which an IIA limits the flexibility of its contracting parties depends on the agreement's scope, as well as on the content and detail of the obligations it enshrines. The broader the scope of an agreement, and the greater the level of detail of its disciplines, the greater the potential for constraints, which host countries may face when setting their public policies. However, IIAs do not tend to impose specific policies on their parties. Rather, they exclude certain measures or policies from the latter's policy options. For the most part, this concerns policies that imply a measure of discriminatory treatment of foreign citizens and companies. Accordingly, one could argue that under the great majority of IIAs (especially under those limited to post-establishment treatment and without prohibition of performance requirements) countries retain considerable freedom to adopt policy options of their choice in regard to social, environmental, and, to a more limited extent, also economic matters – as long as they refrain from discrimination. At the same time, however, countries may feel the need to exclude certain economic areas (sectors, industries and policies) from the obligations imposed by investment agreements. Through reservations, contracting parties afford themselves extra flexibility for these sectors, industries or policies; reservations allow them to apply measures that would otherwise be contrary to the provisions of the agreement.

However, flexibility for public policies does not guarantee that the policies that are implemented will have developmental, social, or environmental outcomes that are better than those of measures that would have to be implemented absent such flexibility. While flexibility can ensure a larger pool of policy options available to achieve certain policy objectives, the results

of such policies remain highly context- and country-specific. In this sense, flexibility is a means to implement policies that are known to be contrary to international disciplines or to preserve this option for the future if uncertainty about future policy choices prevails at the time of negotiations. However, when using this flexibility, countries need to determine – in each case – which policy alternative is the most adequate to obtain the desired objective.

Reservations can either be temporary (i.e. time-bound) or permanent (i.e. non-time-bound). The function of time-bound reservations differs from those that are permanent in nature. Differences exist with respect the nature of the host country's commitments and with respect to the mechanisms for preparing the regulatory framework and the local market participants for future international competition. Temporary reservations allow countries to liberalize gradually, to sequence liberalization efforts and to allow time for the introduction of needed complementary regulatory frameworks. All this is key for promoting an orderly process of liberalization-induced structural change and for ensuring a smooth transition from a restricted to a more liberal policy environment. This also applies to the potential distributional downsides and in-equities, which such changes may bring about. Temporary reservations are thus helpful in affording economic actors the time required to adapt to a changed environment, while at the same time creating credible pressures for structural and behavioural changes to occur.[4]

The case of permanent reservations is different. They allow host countries to fully preserve policies that are deemed necessary as a complement to partial liberalization measures. Such complementary policies may be required to ensure that market-opening decisions deliver the expected benefits and help secure sustainable development objectives. For instance, social regulation

may be needed to ensure that a liberalized investment regime is beneficial for host country workers and that distributional downsides of liberalization are kept to a minimum. Similarly, environmental regulation may be required to ensure that any potentially harmful effects of investment are minimized and properly internalized by responsible economic agents. Another reason for permanent reservations may be precautionary considerations regarding the uncertain development of some economic sectors or regarding the sort of regulation that a country may wish to apply in the future.

Through permanent reservations, the country reserves for itself the ability to comply or not to comply with the obligations of the agreement. Permanent reservations may even allow a country to implement new non-conforming measures, according to the political, social or economic needs that may be (or be deemed) likely to arise in the future. The same logic applies to areas where there is no political consensus at the national level in favour of liberalization. Permanent reservations can thus provide national policy makers the regulatory flexibility they require to put in place the sort of policies necessary to ensure that a country not only attracts foreign investment, but also that the impacts of FDI fit with its long-term development strategy. At the same time, caution might be needed when applying permanent reservations: ultimately, the use of reservations should not frustrate the overall (transparency-enhancing and policy-guiding) objectives of the agreement in question.

Without typically differentiating between temporary and permanent reservations, IIAs generally allow contracting parties to lodge reservations against certain key obligations. This also applies to the recent generation of comprehensive investment disciplines embedded in trade agreements. For the most part, IIAs allow general and policy-oriented exceptions (e.g. on taxation

policies), as well as country-specific reservations (mostly sector-specific) to be lodged against non-discrimination and liberalization disciplines. Examples of IIAs granting flexibility through the lodging of reservations include the North American Free Trade Agreement (NAFTA), which presents a negative list approach to scheduling liberalization commitments in the area of services and investment. NAFTA's overall architecture and liberalization modalities have been replicated in a large number of subsequent agreements, particularly among countries in the Western Hemisphere and most recently in South-East Asia. Another model is the World Trade Organization (WTO) General Agreement on Trade in Services (GATS)-type approach to scheduling commitments. This approach is based on a positive determination of sectors (and modes of supply) in which liberalization commitments are scheduled, combined with a negative list of non-conforming measures. Such an approach can also be found in a number of regional agreements including the Montevideo Protocol of Mercosur or the EU-Chile Association Agreement.[5]

The need for flexibility is arguably greatest for developing countries. This is so, because they face greater social and economic needs than their developed country counterparts, and because many of them are still in the process of identifying the investment policy tools best suited to their particular contexts and levels of development. Developing countries confront a series of challenges in making use of the flexibility afforded under IIAs. In a negative-list approach context, they must typically contend with the up-front need to identify their sensitive sectors and the non-conforming measures they wish to maintain in these sectors. Another challenge arises from the complexity of the modalities for scheduling liberalization commitments commonly found in the recent generation of IIAs. It is sometimes far from clear under which of an IIA’s key obligations a particular non-conforming measure should be lodged.[6] Similarly, some IIAs require

reservation lists to provide a high level of regulatory information. For many developing countries, the above challenges are compounded by the fact that they have yet to determine their best domestic policy options.

Also, as discussed above, the need to identify sensitive sectors and the policy measures to be maintained in them arises within the broader challenge of how to best sequence liberalization efforts and how to put in place complementary (including pro-competitive) regulatory frameworks. The successful mastery of the above challenges requires a high level of expertise, which may not always be available, particularly not in least-developed countries. A closer analysis of the actual practice of scheduling reservations under IIAs, which is one of the central aims of this study, may hopefully contribute to building such expertise.

## B. OBJECTIVE AND CONTENT OF THE STUDY

This study aims to assess the policy options available to IIA contracting parties in order to preserve flexibility in key sectors for regulatory (i.e. to address potential market failures) or other development purposes. To that end, the study first explores the various alternatives that countries have when aiming to preserve flexibility for the economic sectors which they consider strategic or particularly sensitive. The study then reviews patterns of reservations as lodged by parties to eight IIAs. It does so in an attempt better to understand the national policy preferences that motivate such exclusions.

The study’s chapter I focuses on the various techniques used in IIAs to shield individual sectors and policy measures from the scope of legally binding international obligations. The study draws most of its attention on the lodging of reservations under agreements that use a negative list approach to liberalization. As

explained above, such a “list it or lose it”, or “top-down” approach, is one whereby all measures covered by an agreement are subject to its substantive and procedural obligations fully and immediately unless a reservation is explicitly lodged with a view to qualifying or negating such application.

The reason for choosing a sample of IIAs using a negative list approach is, that "top down" agreements generally provide a fuller level of regulatory transparency regarding liberalization commitments and non-conforming measures that are the object of reservations. For agreements relying on a positive listing of committed sectors, the ultimate scope of "reserved" areas is harder to discern. For the purposes of this study, a negative list approach also assumes an extra significance. Since IIAs based on this technique tend to result in the consolidation of the regulatory framework, they can be seen as indications of the sensitivity of the sectors concerned. A larger share of reservations in one economic activity can indicate that in this sector, the country in question pursues policies that do not allow free establishment and/or free operation of foreign investments. A detailed analysis of reservation lists in IIAs reveals – in a transparent way – the particular economic activities where countries perceive the need to maintain greater flexibility and to avoid international obligations. As it will be seen throughout the study, various political or economic reasons may bring about the need for such flexibility. However, whatever these reasons may be, it remains a fact that the more sensitive a certain economic activity is, the greater is the desire to maintain policy options open. Thus, reservations act as a signal of these political and economic concerns.

Chapter II of this study analyses patterns of reservations scheduled by countries in a sample of eight IIAs – Decision 510 of the Andean Pact between Bolivia, Colombia, Ecuador, Peru and Venezuela; the Canada-Chile and United States-Chile Free Trade

Agreements; the G-3 Agreement between Colombia, Mexico and Venezuela; the North American Free Trade Agreement (NAFTA) linking Canada, Mexico and the United States; the OECD’s National Treatment Instrument and the stillborn Multilateral Agreement on Investment; and Mercosur’s Colonia Protocol between Argentina, Brazil, Paraguay and Uruguay.

While it was not possible to obtain broad geographical coverage amongst the parties of the IIAs reviewed (African countries are not covered, and Asian countries only to a very limited extent), the sample includes both developed and developing countries. In fact, the analysis devotes particular attention to the concerns of developing countries. It is hoped, that along these lines, the observations concluding this study will assist developing country policy makers to participate more effectively in the negotiation of IIAs, with a view towards preserving flexibility for domestic development policies.

With this goal in mind, this survey documents the nature, level and sectoral incidence of non-conforming measures maintained in the IIAs under review. Thereby, it reveals the sample countries' preferences for flexibility. The study contrasts reservation patterns across sectors (goods, services and primary sectors, as well as industries within the services sector), across certain policy tools (e.g. discriminatory policies, establishment restrictions or performance requirements) and across groups of countries at differing levels of development. In so doing, the study advances ideas on how countries seek – in practice – to balance the pursuit of market opening policies and their expected benefits in the investment area with the preservation of flexibility.

## Notes

[1] The term "market access" needs to be distinguished from the term "right of establishment". While "market access" refers to non-discriminatory quantitative restrictions for service providers in the sense of Article XVI GATS, restrictions on the right of establishment mean discrimination of foreign investors when making an investment in the host country.

[2] More specifically, paragraph 8 of the São Paulo Consensus states: "The increasing interdependence of national economies in a globalizing world and the emergence of rules-based regimes for international economic relations have meant that the space for national economic policy, i.e. the scope for domestic polices, especially in the areas of trade, investment and industrial development, is now often framed by international disciplines, commitments and global market considerations. It is for each Government to evaluate the trade-off between the benefits of accepting international rules and commitments and the constraints posed by the loss of policy space. It is particularly important for developing countries, bearing in mind development goals and objectives, that all countries take into account the need for appropriate balance between national policy space and international disciplines and commitments" (UNCTAD 2004).

[3] The drafting terminology used to describe the content of reservations may vary between agreements. Thus, the requirements of each agreement should be examined to determine the actual meaning of the terms used.

[4] Countries may, however, introduce regulatory changes long before an agreement is final and binding, allowing governments longer adaptation periods and broader margins for trial-and-error experiences before the deadline of the time-bound reservation is due. Such an approach has been pursued by numerous countries for the implementation of their commitments under WTO and EU accession agreements.

[5] For more on positive and negative listing approaches see below, chapter I.

[6] See the discussion of methodological challenges in Annex 2.

# I. FLEXIBILITY IN IIAs

## A. APPROACHES TO SCHEDULING NON-CONFORMING MEASURES IN IIAs

### 1. GATS-type approach and negative list approach

An important aspect of providing policy flexibility under IIAs relates to the choice of modality used to negotiate and schedule liberalization commitments. Two alternative approaches are found in IIAs:[1] the GATS-type approach, on the one hand, and the negative list approach, on the other.

A GATS-type approach[2] basically means the positive listing of sectors, sub-sectors and (in trade in services) individual modes of supply in which countries voluntarily undertake liberalization commitments. This is combined with the negative listing of the non-conforming measures countries wish to maintain in scheduled sectors, sub-sectors and/or modes of supply. The selective nature of liberalization under this approach entails that an agreement's core obligations apply only to the activities listed in a country's schedule and solely on the terms described therein. Importantly, the terms described in a country's commitments may differ from the regulatory *status quo* prevailing at the time that the commitments are scheduled. Another important implication and defining feature of IIAs relying on a GATS-type approach is that the agreement's obligations do not apply to sectors, sub-sectors or modes of supply that are either listed as "unbound" or that simply do not appear in the country's schedules. This has the advantage of giving host countries greater latitude in determining the overall level of obligations, and in specifying the regulatory conditions under which any commitments are made. For these reasons, the GATS-type approach is generally regarded as more development-friendly than a negative list approach.

Alternatively, countries may rely on a negative list approach. In that case, countries agree on a set of general

obligations and then list all individual measures to which such obligations either do not apply or which qualify their obligations. For example, the NAFTA parties agreed to extend national treatment to all foreign investors and their investments, yet at the same time each of the parties listed those particular measures, sectors and/or activities to which the Agreement's national treatment obligation does not apply, either in part or in full.

A negative list approach is useful for producing a detailed inventory of all non-conforming measures IIA contracting parties maintain. To measures that do not appear in reservation lists the liberalization commitments apply in full *ab initio.* This approach is most appropriate in IIAs involving countries with a high degree of liberalization. Such negative lists are useful from a perspective aimed at comprehensive (and rapid) liberalization: since negative lists provide a full road map of remaining barriers to investment they allow for a rank-ordering of remaining impediments for future liberalization negotiations. In addition, such lists may make it easier for countries to identify possible formula-based negotiating proposals for sectors characterized by similar investment impediments across countries.[3] This, in turn, may further increase the liberalizing character of future negotiations.

As noted above, the negative list approach implies in general the need for host countries to "reveal" the precise nature of investment-restrictive measures enshrined in their laws and regulations. Normally, no such pressure to expose current legislative or regulatory restrictions arises under GATS-type agreements, as host governments can schedule commitments at any desired level of openness or (most likely) restrictiveness. By providing such a snapshot of the prevailing regulatory landscape, negative lists can prove useful for the investment community. They can allow for more informed business decisions to be taken by prospective investors.

There is little doubt that the challenge of preparing a negative list can prove daunting from an administrative perspective, particularly in developing countries suffering from a lack of expertise. Nonetheless, experience suggests that the *process* of preparing a negative list, for which the provision of technical assistance and longer timeframes can and should normally be foreseen, may nonetheless enhance good governance.[4] Such a process may compel host countries to perform an audit of existing regulatory practices in the investment field and to assess the rationale, effectiveness, and continued need for maintaining discriminatory or restrictive investment measures.

The negative list approach usually implies a "standstill" commitment, i.e. the contracting parties are not allowed to introduce new non-conforming measures beyond those included in the negative list. However, some IIAs go further than generating a standstill with regard to sectors subject to the agreement's substantive obligations. Starting with the NAFTA, a number of agreements also feature a so-called “ratchet” effect. Under such agreements any regulatory changes towards further liberalization (whether autonomously, between periodic negotiating rounds or otherwise) are automatically reflected in a country's commitments under the IIA.[5] Such a mechanism may deprive host countries of flexibility that they may not wish to see locked-in (and open to challenge) under international law. For example, this may be the case for sectors in which regulatory regimes and enforcement institutions are nascent, and where the future effects of new liberalization are unclear. A ratchet clause may also deprive host countries of negotiating clout that could potentially be “spent” in the context of multi-sectoral negotiations.

In theory, both positive list and negative list approaches can yield the same outcome in terms of liberalization. This would be the case if countries had the capacity to make informed

judgments about the desirability of maintaining individual measures or, more broadly, about the extent of the commitments they are willing to make. In practice, however, the negative list approach involves a potentially higher level of bound liberalization – to the extent that it locks-in the regulatory *status quo*. This, of course, does not imply that agreements based on positive listing cannot lead to investment liberalization and to *status quo* lock-in. This can, indeed, occur: either as a result of an autonomous policy decision on the part of a host country government, or alternatively due to negotiating pressures arising from bilateral request-offer negotiations (particularly those conducted along North-South lines).

Similarly, and as already noted, even agreements based on a negative list approach may afford some freedom to introduce new non-conforming measures in sensitive sectors. Indeed, most IIAs (featuring either positive or negative lists) concluded in recent years allow countries to list sectors and activities in which future regulatory immunity is preserved. This then becomes the negative list equivalent of an unbound commitment under GATS-type agreements. Moreover, parties to an IIA may always, independently of the chosen scheduling technique, agree to keep some key industries out of the agreement's scope. Adopting carve-out clauses is a tool to this effect (see box 1).

Whatever approach to scheduling non-conforming measures is ultimately used, the overriding concern for a host country is to identify, first, those industries, activities and policy measures against which commitments should be scheduled; and, second, the conditions attached to such commitments in the light of a host country's particular regulatory and developmental circumstances and the competitive strength of its domestic industries.

**Box 1. Carve-out clauses**

One way to preserve flexibility in particular sectors, independently of the sort of IIA concluded (i.e. under a negative or positive list approach), is to exclude particular sectors from the coverage of an agreement. IIA contracting parties can agree to do this through so-called "carve-out" clauses. One notable example of this approach can be found in the GATS. For instance, Article 2 of the GATS Annex on Air Transport Services expressly declares that the agreement shall not apply to transport rights or services directly related to the exercise of such rights.[a] This implies an almost complete carve-out of air transport services from the scope of GATS obligations (except for a few ancillary services mentioned in Article 3). Such carve-outs have been replicated in a large number of economic integration agreements (EIAs) that feature comprehensive investment disciplines. They are also found in the majority of IIAs reviewed in this study.

Another prominent example of carve-outs relates to public services. So-called "public services carve-outs" can be found both in the GATS and in numerous EIAs. IIAs tend to describe public services as "*services supplied in the exercise of governmental authority*" and they are generally understood to encompass services that are neither offered on a commercial (for profit) basis, nor rendered in competition with other *like* services. A narrower variation of a carve-out clause can be found in the Canada-Chile FTA, which excludes in its entirety all measures relating to trade and investment in cultural industries.

Technically, such exclusions do not constitute reservations to the agreements. While their effect might be the same (i.e. excluding certain economic activities from the obligations undertaken) reservations and carve-out clauses differ in nature. Carve-out clauses form an integral part of an IIA and its substantive provisions, and therefore, require the explicit

/…

**Box 1 (concluded)**

consensus of all contracting parties during the negotiating phase of an agreement. Reservations, on the other hand, even if discussed and subject to negotiating pressures in bilateral request-offer discussions, retain a unilateral dimension. Most importantly, for their scheduling they do not require consensus of all the prospective IIA contracting parties. Finally, reservation lists are often revisited in periodic negotiating rounds with a view to achieving progressive liberalization. Carve-out clauses in turn, would require an explicit reopening of an agreement in order to be abrogated or modified.

Overall, carve-out clauses can be an appropriate means to address sectors which all prospective contracting parties of an agreement perceive as particularly sensitive or complex, and which are, accordingly, best left untouched by an agreement's substantive or procedural disciplines. Air transport or public services serve as examples. However, given the broad nature and far-reaching implications of a carve-out, such provisions may not be the best means of addressing economic activities that raise different policy sensitivities across countries or where the need to maintain non-conforming measures may be temporary in nature.

[a] Art. 2 and 3 of the Annex read as follows: "2. The Agreement, including its dispute settlement procedures, shall not apply to measures affecting: (a) traffic rights, however granted; or (b) services directly related to the exercise of traffic rights, except as provided in paragraph 3 of this Annex. 3. The agreement shall apply to measures affecting: (a) aircraft repair and maintenance services; (b) the selling and marketing of air transport services; (c) computer reservation system (CRS) services. "

Of particular importance in this regard is the potential "information asymmetry" that developing countries might experience in confronting the above challenges. This may be problematic to the extent that such countries may not have the

information required to make informed judgements about the nature, scale and scope of the competitive strengths of their domestic industries and hence, of the sectors and policy measures requiring particular flexibility.

Furthermore, the lodging of reservations under a negative list approach, or the absence of a sector from a positive list, may reflect a desire by incumbents (both domestic and foreign) to be shielded from greater international competition. In addition, foreign investors might seek the sweeping opening of sectors at the expense of local competitors. The process of selecting negative or positive list approaches to liberalization may thus be affected by a proper determination of a country’s offensive and defensive negotiating interests in the investment field. Similarly, a host country’s ability to weigh the pleas for protection by special interests may also play a role.

## 2. Examples of the negative list approach

IIAs with a negative list approach are generally perceived as more demanding in terms of regulator transparency, the level of obligations assumed and the extent of liberalization achieved. However, such agreements do not imply the elimination of national flexibility. Nor do they rule out a host country's ability to regulate FDI in sectors subject to IIA disciplines and commitments. Depending on the agreement’s scope and substantive disciplines they can, however, limit a host country’s recourse to certain policy measures and decisions. Notably, this is the case for the desire to retain some space between *applied and bound regulatory policy*.[6] However, such policy limitations are not absolute in character. Indeed, top-down (i.e. negative list) agreements usually afford contracting parties the ability to preserve flexibility for certain sectors by listing existing (and in some cases future) non-conforming measures in reservation lists.[7]

Negative-list IIAs contain different approaches towards the scheduling of reservations. One of the main distinguishing features is the level of information required for the reservations lodged under them. In most cases, host countries are required to provide full details on the nature and scope of the non-conforming measures they wish to maintain or to apply in the future. Such an approach was pioneered under NAFTA. It can also be found in numerous agreements concluded subsequently in the Western Hemisphere and, most recently, in South-East Asia. Of the sample agreements covered by this study, the Canada-Chile and the United Sates-Chile FTAs, as well as the G-3 have opted for this scheduling technique. It can be termed the "elaborated approach" emphasising the degree of liberalization and extent of detail offered.

At the other extreme are IIAs that require contracting parties to merely indicate the sectors in which they intend to maintain or introduce restrictive measures, with little additional detail. The Mercosur countries under the Colonia Protocol for the Promotion and Reciprocal Protection of Investments within Mercosur are an example. Each approach will now be briefly examined.

***(i) Elaborated approach***

Under the NAFTA-type, "*elaborated negative list approach*", the main features of the non-conforming measures must be specified in detail. These typically include the following elements:

- the economic sector in which the reservation is taken;
- the specific industry in which the reservation is taken;
- the activity covered by the reservation, (where applicable) according to domestic industry classification codes;

- the substantive or procedural obligation for which a reservation is taken (e.g. MFN treatment, national treatment, performance requirements, nationality requirements for boards of directors);
- the level of government applying the restrictive measure for which a reservation is taken (e.g. national; sub-national);
- a description of the specific law, regulation or other measure for which the reservation is taken;
- liberalization commitments applying at the entry into force of the agreement, and the remaining non-conforming aspects of existing (or future) measures for which the reservation is taken, if any; and
- phase-out commitments, if any.

With the purpose of promoting transparency and enhancing the predictability of host countries' investment climates, IIAs based on a negative list approach typically inscribe non-conforming measures in various annexes, each of which describes measures differing in nature and scope. For example, the annexes used by the NAFTA contracting parties comprised the following categories:

- *Annex I: Reservations for Existing Measures and Liberalization Commitments*: this Annex encompasses existing non-conforming measures that countries wished to maintain after the entry into force of the agreement. Reservations could be lodged with respect to the following substantive treaty obligations: national treatment; MFN treatment; performance requirements and nationality requirements applicable to boards of directors, as well as local presence (i.e. mandated establishment) requirements applied to cross-border services suppliers. Reservations

lodged under this Annex have to supply the level of informational detail specified above.

- *Annex II: Reservations for Future Measures:* this Annex sets out those economic sectors and activities where new restrictive measures can be implemented in the future – regardless of whether or not the non-conforming measures are currently applied. This category of measures, which can pertain to any of the substantive obligations covered by Annex I reservations, can be compared to sectors, sub-sectors and modes of supply under GATS in which WTO members have either scheduled an "unbound" commitment or that they have left outside their county schedules. The purpose of this Annex is to afford broader flexibility in certain areas for future regulations, allowing the introduction of new non-conforming measures or to tighten existing ones. Unlike the GATS, however, countries lodging such a type of reservation must provide detailed information on the nature of existing non-conforming measures for which future flexibility is being sought.
- *Annex III: Activities Reserved to the State:* this Annex, which is not found in all IIAs using a negative list, was used by Mexico under the NAFTA to reserve measures governing the regulation of activities (including of foreign investment) reserved to the State as decreed in the Mexican constitution (primarily in the oil and gas sector). The unique nature of this Annex meant that Mexico did not need to specify the exact nature of non-conforming measures maintained in sectors subject to Annex III reservations.
- *Annex IV: Exceptions from Most-Favoured-Nation Treatment:* this Annex carves out a number of sectors (as opposed to individual measures as per Annex I) from MFN treatment. It works in a manner analogous to that of exemptions lodged under Article II of the GATS. This

Annex granted the NAFTA countries greater flexibility in the lodging of reservations, allowing them to inscribe whole industries (e.g. "fisheries") without the level of specificity applied to Annex I and II measures.

- *Annex V: Quantitative Restrictions, and Annex VI Miscellaneous Commitments:* these Annexes list non-discriminatory quantitative limitations placed on the cross-border supply of services. Consequently, they relate to measures falling under the services chapter of NAFTA (Chapter 12) as opposed to NAFTA's investment chapter. Because NAFTA did not, unlike the GATS, proscribe the maintenance or enactment of such measures, the three countries agreed to list them solely for transparency purposes and with a view to facilitating discussions on their possible future elimination or liberalization. Despite the non-binding nature of the substantive provisions to which the reservations relate, NAFTA countries agreed to provide full regulatory details.
- *Annex VII: Reservations, Specific Commitments:* while similar to Annex I, this Annex focuses solely on measures in the financial services sector, including with respect to investment in the sector (pursuant to Chapter 14 of the NAFTA). As in Annexes I, II and V and VI, parties agreed to provide detailed regulatory information on the non-conforming measures maintained under this Annex.

Using such an elaborated approach to scheduling may have important implications, both for the ultimate scope of an IIA and for the administrative efforts that such a negotiation process may entail. This is so, in part, because this negotiating modality implies that, unless a reservation is taken, all future measures are automatically subject to the agreement's liberalization obligations – without qualification and in sectors/activities that do not yet exist, or where regulatory frameworks are not (or not fully) in

place at the time when the IIA enters into force.[8] In contrast, under agreements based on a GATS-type approach, flexibility is more readily available. This is so both in terms of the ability of host countries under positive list IIAs to choose not to lock-in the *status quo* if they so desire, as well as with regard to the discretion they retain for future regulatory conduct in the covered sectors.

At the same time, negative listing can bring gains in transparency, as well as the expected benefits of good governance and an enhanced investment climate that may accrue in the wake of the preparation of negative lists. It should be noted, however, that the supposed gains in transparency and in policy consolidation that can arise from an elaborated approach to negative listing can be seriously undermined if Parties to an IIA allow sweeping general reservations to be lodged. For instance, in its FTA with Chile, the United States has lodged an Annex I reservation that exempts "all existing non-conforming measures of all states of the United States, the District of Columbia, and Puerto Rico". This carves-out from the agreement's scope all non-conforming measures maintained at the sub-national level without providing any information on the nature, type and sectoral incidence of the restrictive measures concerned.

As indicated above, the conclusion of an IIA with an elaborated negative list approach requires dedicated efforts at identifying and assessing all potential non-conforming measures. This, in turn, demands a sound system of inter-agency coordination within governments and equally effective consultative mechanisms with civil society and private sector organizations. To make the best use of a negative list, host countries must indeed have full knowledge of the rationale for, effectiveness of, and possible continued policy need for particular types of non-conforming investment measures (including, where relevant, at the sub-national level). Failure to lodge a specific reservation will result in the

subsequent need to rescind its possible non-conforming nature, or run the risk of seeing its maintenance challenged under an IIA's dispute settlement procedures.

While deficiencies and weaknesses in internal and external coordination and constraint mechanisms are by no means unique to developing countries, the associated administrative burden tends to weigh more heavily on resource-constrained administrations. The same applies to the consequences of making a mistake in completing such lists. For this reason, administrative capacity needs to be carefully assessed before entering into IIAs involving the generation of elaborated negative lists of non-conforming measures. This could give rise to technical assistance requests as a *quid pro quo* for agreeing to such a negotiating modality.

***(ii) Alternatives to the elaborated approach***

There are, however, alternatives to the elaborated approach. They can be found in the technique favoured by Canada and the United States in their bilateral investment treaties (BITs), as well as by the Mercosur countries under the Colonia Protocol for the Promotion and Reciprocal Protection of Investments within Mercosur. Under these IIAs reservation lists require contracting parties to indicate what sort of non-conforming measures they wish to maintain in a given sector without the above-described level of regulatory detail. This reduces the administrative burden on national authorities when lodging reservations. Under such IIAs, host country governments are neither required to indicate the specific law, regulation or provision for which the measure is taken, nor are they obliged to mention whether such a measure exists at present or whether it might be implemented in the future.

The three types of IIAs essentially all endeavour to provide some degree of transparency on host countries' investment regimes

by indicating the nature of the non-conforming measures and the sectors where they apply. By looking at the reservation lists produced under these types of IIAs, it is possible, for instance, to determine whether road transport services are subject to national treatment restrictions, whether certain performance requirements are maintained in the telecommunications sector, or whether the establishment of foreign investors in mining is allowed.

The nature of the measures listed in reservations under this approach depends on the scope and substantive obligations of the relevant IIA. If an agreement features specific provisions addressing various types of investment impediments (e.g. discrimination, performance requirements, restrictions on key personnel, quantitative restrictions on entry), the reservation lists will also tend to document non-conforming measures linked to various types of restrictions. On the other hand, if the IIA encompasses various categories of impediments solely under overarching non-discrimination principles (national treatment and MFN treatment), the information generated by the reservation lists will lack specificity and therefore generate more limited gains in terms of transparency and policy predictability.

IIAs that follow this alternative approach to scheduling typically require contracting parties to specify: whether restrictions relate to the pre- and/or post-establishment phases of an investment; to obligations on MFN treatment and national treatment; to performance requirements (usually encompassing technology transfers) or to the movement of key personnel.

In its Foreign Investment Protection Agreements (FIPAs), Canada, for instance, records non-conforming measures relating to national treatment as follows:

- "*National Treatment Exceptions* (covers national treatment obligations in regard to obligations concerning pre- and post- establishment treatment, as well as particular provisions in regard to movement of key personnel)*:*
  - social services (i.e. public law enforcement; correctional services; income security or insurance; social security or insurance; social welfare; public education; public training; health and child care);
  - services in any other sector;
  - residency requirements for ownership of oceanfront land;
  - measures implementing the Northwest Territories Oil and Gas Accord;
  - government securities."[9]

Unlike for NAFTA-type agreements, countries following this intermediate approach do not need to be as detailed with regard to the legal description of the non-conforming measures they wish to maintain. Rather, in some cases, contracting parties have agreed merely to indicate the economic sector (e.g. financial services) and the obligation (e.g. national treatment) to which the reservation pertains. Such an approach may make the scheduling process easier: the task for host countries to scan their domestic laws and regulations prior to entering into an agreement in order to lodge reservations becomes less demanding. Moreover, such an approach allows for the maintenance of what may be called “precautionary” reservations that need not correspond to existing measures. It thereby preserves broad regulatory discretion for future measures destined to secure the attainment of national policy objectives, such as environmental or developmental purposes.

There can, however, also be potential downsides to this intermediate approach to negative listing. They would stem from the fact that reservations, if lodged too broadly, may generate sub-

optimal gains in regulatory transparency and reduce an IIA's ability to enhance a host country's investment climate. For this reason, attention could be given to yet another alternative approach to scheduling, one that would aim to combine the best features of the various approaches of negative and of GATS-type listing.

## B. OTHER ALTERNATIVE FOR FLEXIBILITY

As mentioned above, a third option may be available for prospective IIA contracting parties who are interested in reaping the potential governance and transparency-enhancing features of a negative list approach while avoiding the possible negative effects concerning the reduction of flexibility that such an approach might entail. Such a third approach would retain a GATS-like positive/hybrid list approach for purposes of lodging legally binding sector-specific liberalization commitments and qualifications thereto. It would also preserve host countries' flexibility with regard to future measures by allowing them to lodge "unbound" commitments or to keep particular sectors or activities out of their schedules or to schedule commitments below the regulatory status quo. In addition, countries would agree to exchange (and append to their IIA obligations) comprehensive (but not legally binding) lists of all non-conforming investment-related measures (i.e. measures that violate obligations such as national treatment, absence of market access/non-discriminatory quantitative restrictions, most-favoured-nation treatment, absence of local presence requirements, among others) for those sectors and sub-sectors which they have either not scheduled, scheduled as unbound or scheduled at less than the regulatory status quo. Such an approach would help prevent situations in which a host country's inability to properly reflect all potentially "non-conforming" measures would inadvertently result in obligations under the IIA – a risk most likely to arise in countries with weak administrative resources. A non-binding negative list of this sort

could nonetheless generate important transparency enhancing effects.

Thus, the purpose of such lists would be two-fold, both of them related to the enhanced transparency this approach would generate. First, it would encourage host countries to perform a domestic audit of their existing investment regimes. And second, it would provide a precise overview of existing impediments to investment. These lists could be used as a roadmap for preparing future negotiations aimed at increasing liberalization and could help prospective foreign operators to make informed investment decisions. The non-binding nature of such lists, the preparation of which might benefit from technical assistance for developing countries, would avoid the risk of (inadvertently) loosing future regulatory sovereignty, a problem implicit in IIAs based on elaborated negative listing.

Countries may also consider the possibility of setting up an institutional framework for the purposes of reviewing the implementation of the agreement. This may include the establishment of a committee responsible for the agreement and a timetable for its implementation. Such a common institution should ideally have the effect of supporting the negotiating process and of facilitating the review of the agreement according to the needs of the parties and its subsequent evolution – over time – in light of the developmental and other impacts it brings about. A large number of preferential trade and investment agreements signed to date contain such mechanisms.

## Notes

[1] IIAs following either of these approaches feature obligations on pre-establishment rights. European BITs, for their part, do not generally

include any list of reservations nor enshrine pre-establishment rights. See on this UNCTAD 2004, Solé 2003, and Torrent and Molinuevo 2004.

[2] GATS-type positive listing requires signatory countries to take two steps when undertaking commitments: first, to identify the economic activities (services industries, and, in the case of the GATS also for the mode of supply) where they will take a commitment; second, to specify for each industry (and in the GATS also for the mode of supply) the particular restrictions they wish to apply, if any. The GATS-type approach is therefore called a hybrid approach. In principle, a third approach would be possible: that of "pure" positive lists, where countries would indicate the economic sectors that they wish to subject to the agreement's disciplines, with no further qualifications. It would be equivalent to entering a "none" limitation in each sector and sub-sector the country has listed in its schedule, without inserting any particular conditions or limitations on national treatment, market access or additional commitments for each of them. Such an approach has not, however, been used in IIAs concluded to date.

[3] Formula-based negotiations on investment liberalization may take into account, for instance, sectoral participation, contribution to GDP, total number of measures restricting FDI, and/or other quantitative elements. Thus, they may help to ensure a common basic degree of mutual liberalization between the parties, while deeper and more specific commitments can be pursued on a request-offer approach. While formulas can be used in the context of GATS-type positive lists as well, the binding of the regulatory status quo normally attained through negative listing would provide a more adequate background for their use as a liberalization mechanism. For a fuller discussion of formula-based approaches to services and investment liberalization, see Thompson 2000.

[4] In this context, the regulatory role of sub-national entities (states and provinces) is of considerable importance, particularly in federal countries. In fact, sub-national entities usually retain regulatory competences in a number of investment-related matters. In this regard it is instructive that NAFTA granted sub-national governments (states and provinces) two additional years to complete their negative lists of non-conforming measures, albeit without providing for technical assistance in the preparation of the lists. During the two-year period, NAFTA parties had agreed on a standstill clause for non-conforming measures applied at the sub-national level. At the request of Canada, and owing to concerns

expressed by a number of provincial governments over the extent to which all potentially non-conforming measures would need to be listed, including in the field of public services, NAFTA parties agreed not to produce negative lists at the sub-national level but to allow the maintenance of (i.e. to "grandfather") existing non-conforming measures.

[5] Such a provision can be found in Article 1108.1.c (Reservations and Exceptions) of the NAFTA, which reads as follows:

"Article 1108 Reservations and Exceptions

*1.*Articles 1102 (National Treatment), 1103 (Most-Favored Nation Treatment), 1106 (Performance Requirements) and 1107 (Senior Management and Boards of Directors) do not apply to:

(a) any existing non-conforming measure that is maintained by (i) a Party at the federal level, as set out in its Schedule to Annex I or III; (ii) a state or province, for two years after the date of entry into force of this Agreement, and thereafter as set out by a Party in its Schedule to Annex I in accordance with paragraph 2; or (iii) a local government;

(b) the continuation or prompt renewal of any non-conforming measure referred to in subparagraph (a); or

(c) an amendment to any non-conforming measure referred to in subparagraph (a) to the extent that the amendment does not decrease the conformity of the measure, as it existed immediately before the amendment, with Articles 1102, 1103, 1106 and 1107. "

[6] This distinction refers to the difference between a host country's actual FDI policies (i.e. "applied") and the degree to which it subjects these policies to international commitments (i.e. "bound"). For instance, while a host country currently allows foreign investment in a certain economic sector without restrictions, it may nevertheless wish to preserve flexibility for introducing limitations in the future, and therefore take a reservation in the IIA.

[7] Such an approach can be found in a number of IIAs, notably those concluded among countries in the Western Hemisphere, starting with the North American Free Trade Agreement (see the depiction of so-called "Annex II" reservations of the NAFTA in the following section).

[8] Note that this is the case, except for activities to which Annex II reservations apply.

[9] While the exceptions cited correspond to the Canada-Croatia FIPA of 1997, they tend to be found in all IIAs entered into by Canada, whether at the bilateral, regional or multilateral levels.

# II. REVEALED POLICY PREFERENCES: RESERVATION PATTERNS IN SELECTED IIAs

Having discussed the various methods IIA contracting parties can use for scheduling reservations and qualifying liberalization commitments, the study turns to the actual pattern of reservations, as they are found in the sample of negative list agreements. The subsequent analysis maps the investment policy preferences that are revealed by the reservation lists the parties have appended to the sample of eight IIAs. As mentioned above, the sample includes IIAs adopted by countries at various stages of economic development and comprises the following agreements:[1]

- Andean Pact (Decision 510): Bolivia, Colombia, Ecuador, Peru, Venezuela;
- Canada-Chile and United States-Chile Free Trade Agreements;
- G-3 Agreement: Colombia, Mexico, Venezuela;
- Mercosur Colonia Protocol: Argentina, Brazil, Paraguay, Uruguay;[2]
- North American Free Trade Agreement (NAFTA): Canada, Mexico, United States;
- OECD National Treatment Instrument (30 OECD members, plus 9 non-member countries);[3]
- Draft OECD Multilateral Agreement on Investment (negotiated between the Members of the OECD and with a few non-Member countries such as Argentina, Brazil, Chile, Hong Kong (China) and the three Baltic countries participating as observers, but never concluded).

As noted above, the analysis in this chapter is based on a sample of agreements that follow a negative list approach to scheduling non-conforming measures. The choice of this sample of IIAs is based on several considerations. First, agreements featuring a negative list approach are prevalent in number. Second, and especially important for analytical purposes, negative list agreements allow for a significantly clearer depiction of the

regulatory preferences of contracting parties in the investment field. This is so because, as mentioned earlier, "top-down" IIAs typically generate reservations that bind the regulatory *status quo* prevailing at the time of an agreement's entry into force and thus imply that the level of policy consolidation can more easily be discerned. Overall, an effort was made to select a set of similar agreements, which should enable comparisons and conclusions to be drawn.

However, particular care must be taken when interpreting the results presented in this chapter of the study. Most importantly, such caution is required because of the inevitable measurement difficulties encountered in this type of exercise. Annex 2 summarizes a number of the methodological challenges faced in preparing the statistical information presented in this study and in the policy conclusions that can be drawn from such data. Along these lines, results should be interpreted more in the sense of describing general trends, rather than in their actual numerical values. Also, it should be kept in mind that different instruments do not necessarily impose identical obligations. Naturally, these differences impact on the content of the reservation lists. Moreover, countries are not always equally precise in their categorization of sectors: while some lodge reservations for specific services, others may prefer to lodge broader exceptions for sub-sectors. These different approaches result in huge differences in absolute numbers of reservations. It is therefore preferable to concentrate on percentages.

The investment-related measures in regard to which a reservation can be taken under the sample IIAs reviewed relate to the following disciplines: a) MFN treatment; b) national treatment; c) market access (i.e. non-discriminatory quantitative restrictions); d) performance requirements; e) movement of key personnel; f) right of establishment; and g) other.[4] The latter category includes

measures such as nationality requirements applied to board of directors and measures relating to the operation of the agreements' dispute settlement provisions (especially investor-state dispute settlement).

## A. OVERALL PATTERNS OF RESERVATIONS

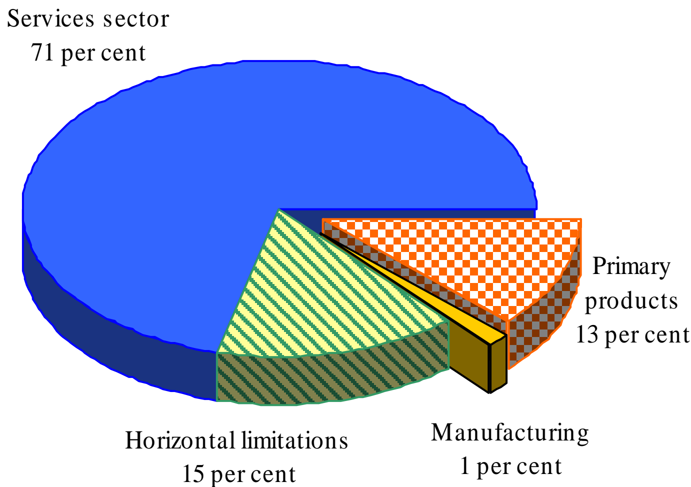
The empirical results (based on the reservation lists appended to the IIAs under review) indicate that out of the 4806 non-conforming measures scheduled under the eight sample IIAs, close to three quarters (71 per cent) are maintained in services. These are followed by so-called "horizontal" measures, which apply to investment in all sectors (the bulk of which also relate to services given their predominance in the gross domestic products of sample countries).[5] The number of reservations for services is six times higher than the number of reservations for primary industries (agriculture, mining and fisheries). Meanwhile, the results depicted in figure 1 reveal the negligible degree of investment restrictions directed towards manufacturing activities, which account for a mere 1 per cent of total non-conforming measures in the sample IIAs.

The above trend is clearly visible in figures 2 and 3, which provide a detailed breakdown of the sectoral incidence of non-conforming measures found in the individual IIAs of the sample. Figure 4 reveals a similar trend when looking across groups involving countries at different levels of development: the share of non-conforming measures in services ranges from 76.9 per cent in the case of Canada and the United States; and 81 per cent in the Latin American sample countries (Argentina, Brazil, Colombia, Chile, Mexico and Venezuela); to 94.1 per cent in the case of former transition economies that are now part of the EU (e.g. Czech Republic, Hungary, Poland). The high share of services reservations in transition economies might – to a large extent – be

due to the number of restrictions applied to financial services. In fact, the financial services sector accounts for over a quarter of total reservations in services. Such a trend may not be surprising when one considers that countries transiting from a centrally planned to a market economy may want to preserve greater regulatory flexibility for sectors such as banking and insurance that had not operated as normal, commercially-based industries before. Similarly, a fair dose of regulatory precaution may originate from the adverse, economy-wide repercussions that market failure in this industry may bring about.

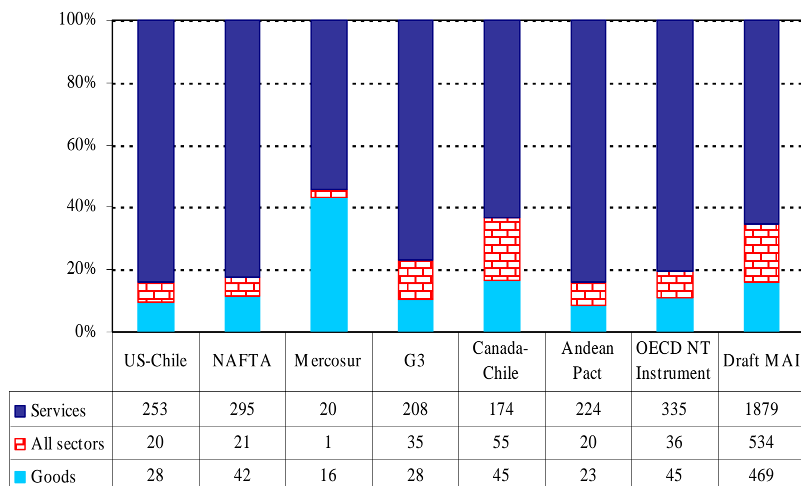
**Figure 1. Reservations on investment by economic sector, total of all agreements**

US-Chile, NAFTA, Mercosur, G3, Canada-Chile, Andean Pact, OECD NT Instrument, Draft MAI




*Source*: UNCTAD IIA database.

**Figure 2. Composition of reservations on investment, by sector**
(All agreements)



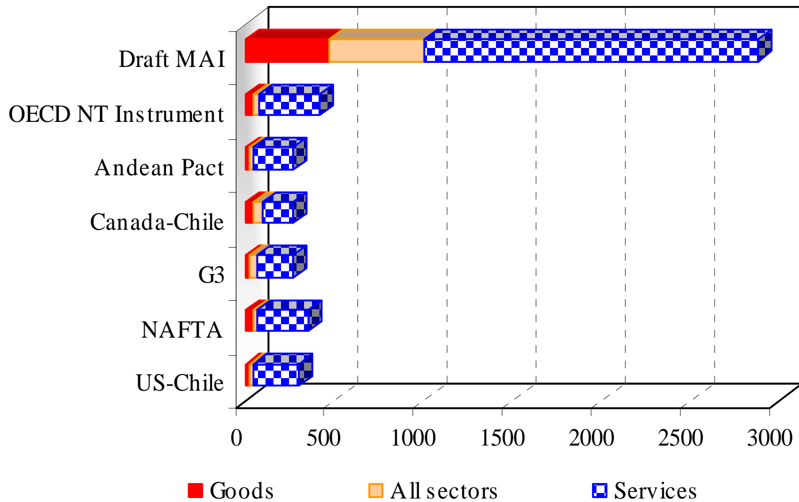

| | US-Chile | NAFTA | Mercosur | G3 | Canada-Chile | Andean Pact | OECD NT Instrument | Draft MAI |
|---|---|---|---|---|---|---|---|---|
| Services | 253 | 295 | 20 | 208 | 174 | 224 | 335 | 1879 |
| All sectors | 20 | 21 | 1 | 35 | 55 | 20 | 36 | 534 |
| Goods | 28 | 42 | 16 | 28 | 45 | 23 | 45 | 469 |

*Source*: UNCTAD IIA database.

There may be several reasons for this higher incidence of reservations in the services sector. First, there is little doubt that the prevalence of services reservations reflects the higher average level of regulatory activity (as a result of the greater scope for market failure) encountered in many services markets.[6] The fact that policy sensitivities towards foreign ownership tend to be most pronounced in the services sector may also reflect the central role that industries such as finance, telecommunications and transportation play in economy-wide terms. The more political (and sometimes protectionist) sensitivities that prevail in sectors such as broadcasting, media and audio-visual services may be

another reason. Similarly, service industries such as education, health and environmental services (e.g. water distribution) may be

**Figure 3. Reservations on investment by agreement and sector[a/]**



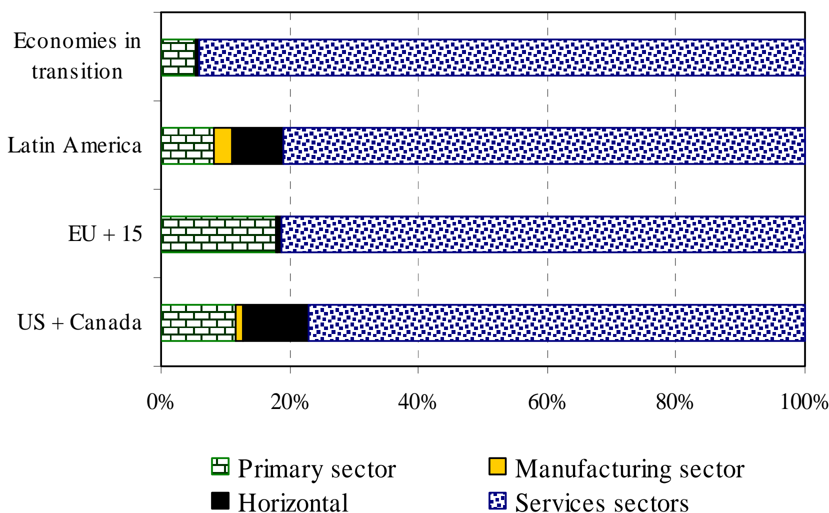

*Source*: UNCTAD IIA database.

a/ This figure does not include Mercosur due to the small number of reservations lodged under that agreement.

deeply embedded in countries' social contexts. This may often require a higher degree of governmental regulation and give rise to particular sensitivities regarding the role of private providers and foreign suppliers in such activities. Finally, the services sector encompasses a number of activities that have been, or still are, subject to state ownership, where monopolistic or oligopolistic market structures often prevail, or where foreign investment remains subject to close governmental scrutiny and prior approval procedures. To all this, one would need to add the fact that some

two-thirds of aggregate FDI flows have in recent years been directed towards the services sector. With this in mind, it is perhaps less surprising that services would assume such prominence in the reservation lists of IIA contracting parties.

**Figure 4. Reservations on investment by group of countries**




*Source*: UNCTAD IIA database.

By contrast, and as noted above, the amount of reservations found in the primary sector is comparatively small and in the manufacturing sector truly marginal. Agriculture, fisheries, forestry and mining (resource extraction) activities exhibit a higher degree of restrictions to foreign investment than does manufacturing. In part, this reflects policy sensitivities regarding ownership and exploitation rights in natural resource industries. This may, in turn, be an expression of both strategic and, increasingly, environmental concerns.[7] In fact, a significant number of reservations in the

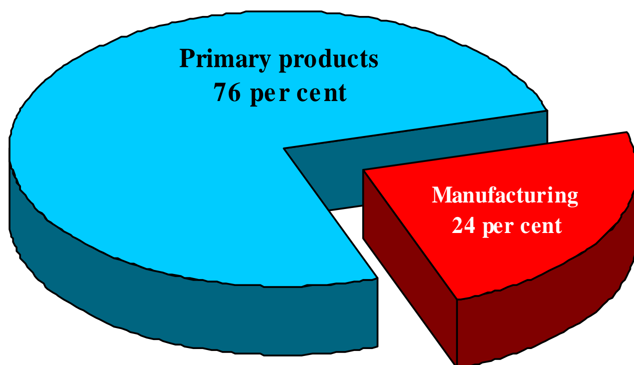
primary sector relate to protective policies concerned with the exploitation of natural resources. This is particularly the case for fisheries and agriculture. There are, however, important differences between these two primary activities: while restrictions to foreign investment in fisheries tend to be maintained by developed and developing countries alike, restrictions on investment in agriculture primarily concern developed countries.[8] As regards limitations on entry and operation in the oil and gas industry, these tend to be more prevalent in developing countries. This also reflects the fact that some developing countries are major exporters of energy, oil- and gas-related products. The exploitation of these energy resources and products is often in the hands of state-owned enterprises or otherwise subject to tight control by host country governments.

The manufacturing sector seems to be almost immune from the high level of explicit entry and post-establishment operation barriers found in services. Figures 5a and 5b document the extent to which goods-related investment restrictions arise in manufacturing as opposed to primary industries. Such a trend is most pronounced in developed countries, where restrictions in primary industries dwarf those applying to manufacturing by a factor of 19 to 1. The corresponding ratio is notably lower for developing countries, where restrictions in primary activities nonetheless still outstrip those found in manufacturing by a 3 to 1 ratio.

The policies of openness and non-discrimination, which countries maintain with respect to investment in these sectors is – to some extent – matched by the circumstances prevailing in international trade in industrial goods.[9] Indeed, manufacturing is the area where foreign investors are most likely to enjoy better than national treatment, benefiting from various targeted fiscal incentives aimed at attracting and retaining foreign investment in

host economies. Contrary to performance requirements, the latter policies are generally not subject to specific IIA disciplines. Broadly, this is also true with respect to the WTO. The WTO's Agreement on Subsidies and Countervailing Measures (SCM) introduces only indirect and narrow disciplines on the trade-distorting effects of investment incentives, not covering fiscal incentives (Sauvé 1997).

**Figure 5a. Reservations in goods-related activities**
**Developing countries**



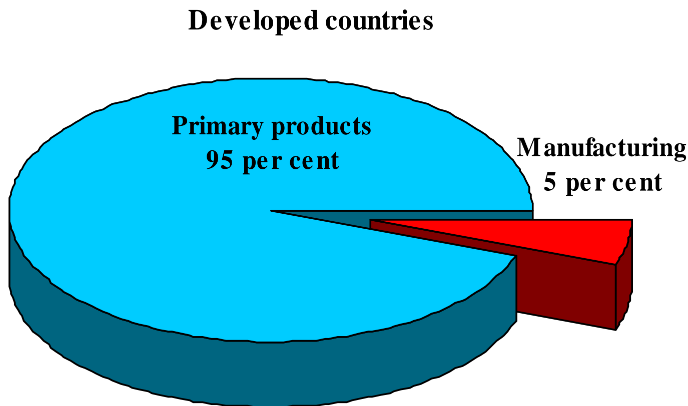

*Source*: UNCTAD IIA database.

Finally, there are the horizontal reservations, which account for 15 per cent of total reserved measures (see figure 1). Most of them relate to investment screening and prior approval/licensing requirements governing the establishment of foreign-owned enterprises and the acquisition of a domestic enterprise by a foreign one. They also relate to discriminatory requirements for eligibility for domestic subsidy programmes. In fact, such programmes frequently take the form of preferential loans, which are reserved to firms that are owned and/or controlled by nationals. Finally,

horizontal limitations are often implemented for statistical and general monitoring purposes.

The overwhelming share of reservations found in the services sector suggests the need to take a closer look at their nature, sectoral incidence and differing patterns (if any) across countries at differing levels of development. The next section will aim to address these aspects.

**Figure 5b. Reservations in goods-related activities**




*Source*: UNCTAD IIA database.

## B. SERVICE SECTOR RESERVATIONS

### 1. Sectoral incidence

Certain services sectors can be particularly sensitive for host countries' social and economic development. Financial (banking and insurance), communications and other infrastructure services, as well as health, educational or sanitation services may

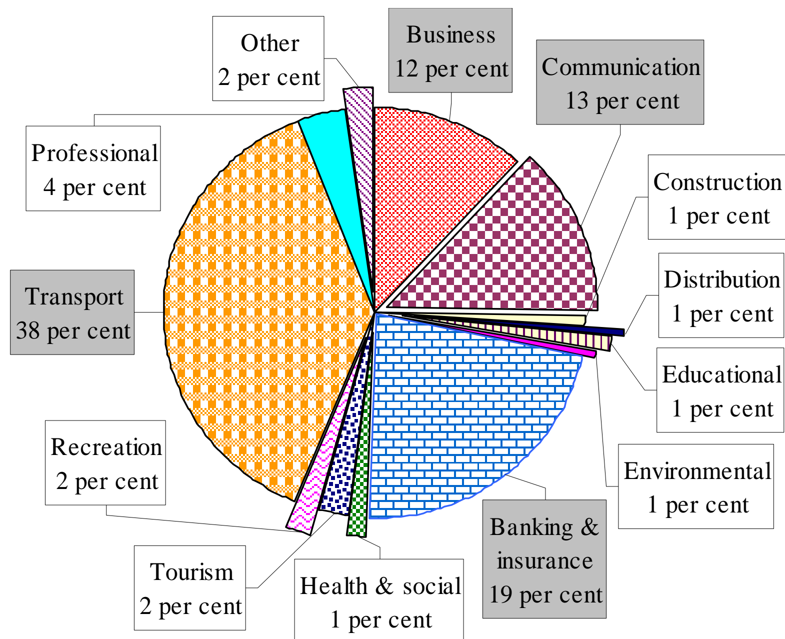
serve as examples. As a result, governments may be reluctant to undertake extensive international obligations, if the latter could affect the regulation of these sensitive services activities. Reservation lists provide useful barometers for assessing cross-country differences in the nature and sectoral incidence of policy sensitivities related to investment in services.

As figure 6 reveals, four services industries (out of an aggregate 12 categories) account for an overwhelming share of the total non-conforming investment measures in this study's sample of IIAs. Transportation, banking and insurance, business services[10] and communications account for a combined 82 per cent of total non-conforming measures listed in the services sector. Amongst the four, the transport industry is by far the most restrictive, accounting for close to two out of every five (38 per cent) impediments found in the sample reservation lists. Financial services accounts for another fifth (19 per cent) of total non-conforming measures.

The reservation pattern depicted in figure 6 begs the question why transportation stands out as a sector in which the preference to preserve flexibility is so pronounced. Transport services have long been carved out of broader trade agreements as countries have typically pursued bilateral negotiations (the objective of such bilateral approaches being both to exchange reciprocal market access opportunities and to limit competition in the fields of air, maritime and land transport). The high incidence of transport sector reservations is even more surprising when one considers that the air transport sector is broadly excluded from the scope of most IIAs covering the pre-establishment phase, as is the case under the GATS. In fact, this would suggest that few reservations are actually lodged under this transport mode. Rather, the bulk of non-conforming measures relate to maritime transport services, particularly in respect of cabotage-related matters[11] and

inland waterways, as well as land transport (bus, truck and rail services) and to a range of services incidental to both transport modes.

**Figure 6. Reservations on investment in services by sector**
All agreements




*Source*: UNCTAD IIA database.

In the IIAs under review, several reservations in transportation services are common across countries and agreements. Figure 7 shows that the most common treaty obligations against which reservations are lodged in the sector relate to national treatment, local presence (i.e. forced establishment requirements), MFN treatment and, to a lesser

extent, movement of key personnel. Some of the most common restrictions cover the:[12]

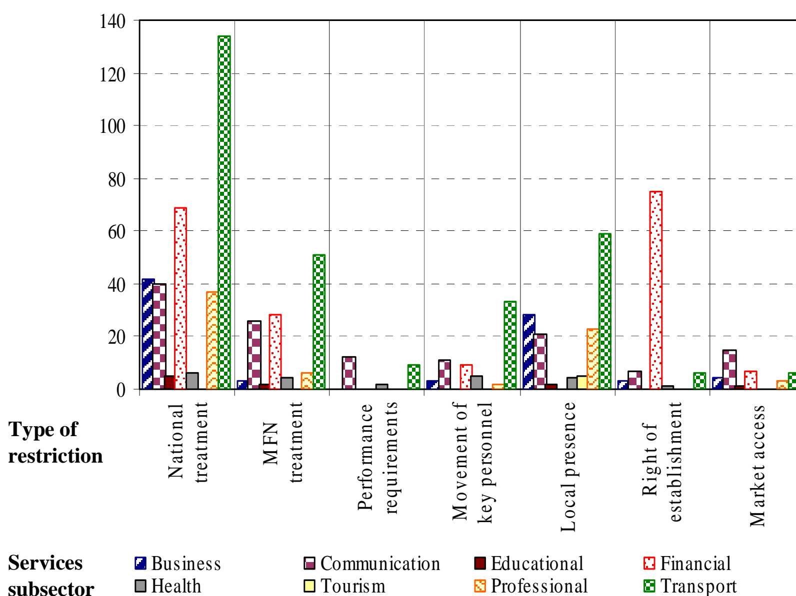
- *maritime transport sector:* 1) maritime transport reserved to national flag vessels; 2) only national companies or persons may acquire national flag vessels.
- *road transport sector*: 1) cabotage and other transport services are reserved to national hauliers, unless otherwise agreed in bilateral and multilateral agreements.

Also financial services exhibit considerable regulatory sensitivities. These sensitivities and the leading role that foreign investment (commercial presence) assumes in contesting financial markets are revealed by the fact that all sample countries, developed and developing, have lodged numerous reservations in this sector. Financial services reservations relate to three core IIA obligations: national treatment, MFN treatment and the right of foreign financial institutions to establish a presence in a host country (see figure 7). Limitations on foreign equity participation top the list of national treatment limitations in the sector. Such limitations aim to ensure some degree of national control over an activity that may constitute the backbone of an entire economy.

Limiting MFN treatment through reciprocity requirements is another frequently encountered measure in the financial industry. These MFN reservations may be due to the large number of reciprocal arrangements (for both market access and prudential reasons) maintained in the sector. The fact that the financial services sector is, among all service sectors, the one where the highest number of entry (i.e. right of establishment) barriers are maintained, particularly by developing countries, suggests that many host countries are concerned about the need to regulate and properly circumscribe the nature and extent of competition in domestic financial markets. However, such limitations may also reflect successful lobbying by incumbents, domestic and (often)

foreign, to limit the prevailing level of competition in financial markets either by restricting the number of new entrants or by raising their cost of entry.

**Figure 7. Reservations on services by type of measure**
(US-Chile, NAFTA, Mercosur, G3, Canada-Chile agreements)




*Source*: UNCTAD IIA database.

The need for broader national regulatory space can also be found in the areas of business and communication services. In both sectors, national treatment limitations that allow discriminatory measures (those favouring domestic over foreign firms) are the most common types of reservations. They are followed by measures relating to local presence, which is frequently required as

a pre-condition for obtaining a license to operate. Such requirements are also prevalent in professional services and typically respond to consumer protection imperatives. Consumer protection measures may respond to the potential for market failures, which, in turn, arise from the considerable information asymmetries between users and suppliers of professional services.

Also the communication sector features a number of reservations limiting MFN treatment. More specifically, these relate to existing (or future) co-production agreements in audio-visual services. Communications is also the service sector with the greatest number of reservations relating to non-discriminatory quantitative restrictions (so-called "market access" limitations). This may reflect the particularities of telecommunications as a sector in which monopolistic and, especially oligopolistic, market structures have prevailed for a long time. Similarly, the high number of such reservations may reveal the fact that in telecommunications, regulatory concerns relate to issues such as anti-competitive practices and the need to guarantee the supply of public services to the domestic population.

Reservations are also found in sectors such as recreation, tourism, health, social, education, and construction services, but they tend to be less significant in number. Reservations on recreation services relate mainly to gambling services, a sector that is often subject to strict governmental screening and licensing procedures and where the establishment of foreign enterprises and national treatment are of sensitive nature. The limited number of reservations in health, social, education and environmental (water distribution) services may – at a first glance – be surprising. However, the low incidence of reservations must be correlated to the overall paucity of liberalization commitments in these sectors and to the fact that large elements of these sectors are considered to be carved out from the IIA. In many IIAs this happens in a manner

analogous to Article I.3.b of the GATS which excludes services supplied in the exercise of governmental authority (OECD 2002, UNCTAD 2004). Many of these services are key to a society's human development and its economic competitiveness and they display strong public goods characteristics. Therefore, governments frequently impose universal service obligations, aimed at extending the service to the poor and marginalized segments of society. While significant policy differences arise across countries regarding the most appropriate means (and adequate market structures) to secure compliance with the above objectives, there seems to be an overall consensus that careful regulation, appropriate flexibility, and precaution under IIAs may be warranted in these sectors.

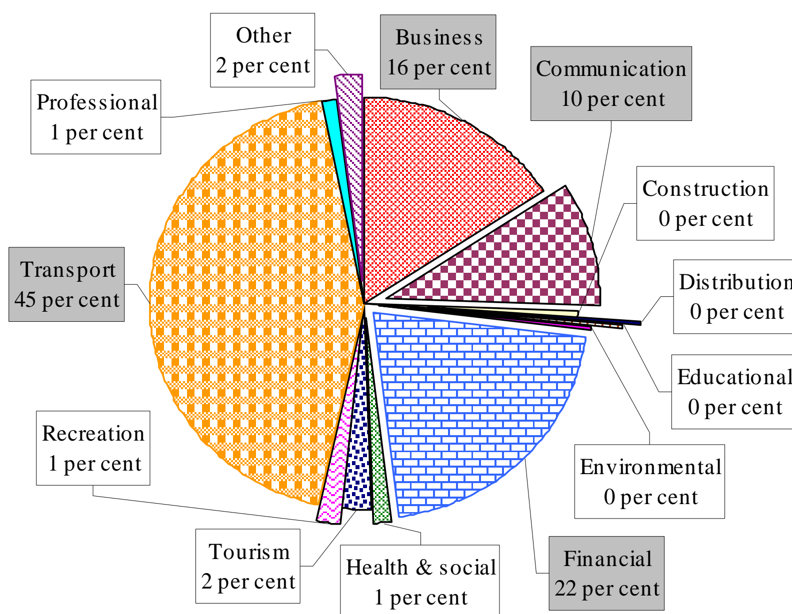
Also distribution services are noteworthy. Distribution is a sector where, apart from Mexico, hardly any reservations have been lodged by the developing countries in the sample. This is somewhat surprising given the potentially dislocating (e.g. crowding-out) effects that the entry of large-scale distributors can have for smaller domestic competitors. Apart from financial services, distribution services are one sector that features prominently in ongoing discussions, particularly under the GATS, on the desirability of developing emergency safeguard mechanisms. Such mechanisms could constitute a tool to help address unanticipated dislocations resulting from service sector liberalization commitments.

## 2. Cross-country incidence

The data in figures 8 and 9 offer a contrasting perspective on the sectoral incidence of service sector reservations in developed and developing countries. The figures reveal a series of interesting aspects. First, the four sectors that account for the vast majority of aggregate reservations are transport, finance, business,

and communications services (suggesting that these are also the sectors where the bulk of non-conforming measures is found). This applies to both developed and developing countries. However, the relative importance of these sectors differs significantly according to income levels. Finally, the four leading sectors account for a

**Figure 8. Patterns of services sector reservations**
Developed countries

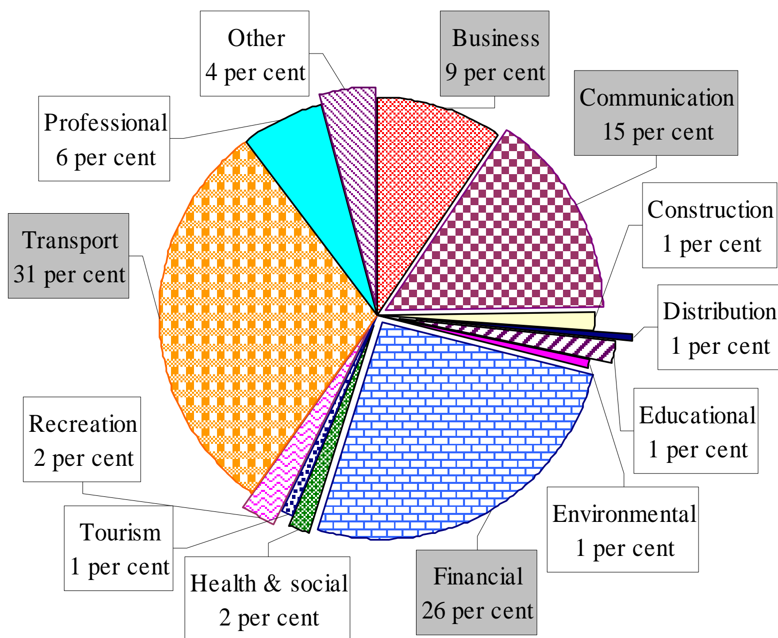



*Source*: UNCTAD IIA database.

larger share of total reservations in developed countries (93 per cent) compared to developing countries (81 per cent). For

developing countries, their preference for preserving flexibility spans a broader set of service sectors.

**Figure 9. Patterns of services sector reservations**
Developing countries




*Source*: UNCTAD IIA database.

A comparison along income lines also reveals the significantly higher share of transport-related restrictions in developed countries, where they account for 45 per cent of all service sector reservations, as opposed to 31 per cent in developing countries. Also noteworthy is the greater incidence of non-conforming measures maintained by developing countries in the

communications sector, where they account for roughly one in 7 non-conforming measures (or 15 per cent of the total), as opposed to one reservation in ten (10 per cent) in developed countries.

The data also show that the incidence of reservations in financial services is extensive in both developed and developing countries. However, the latter exhibit a higher average share of non-conforming measures in the sector (26 vs. 22 per cent). Such a difference may be expected given the less developed nature of domestic financial markets and regulatory institutions in developing countries and the greater regulatory precaution that financial market turmoil has induced in many emerging market economies in the wake of the 1997-1998 Asian financial crisis.

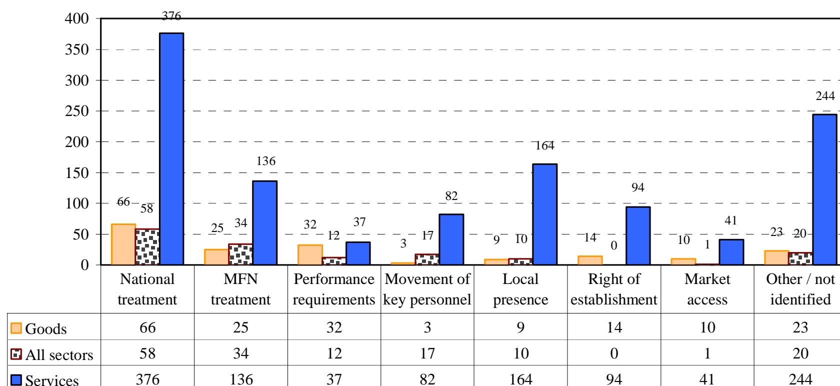
## C. RESERVATIONS BY TYPES OF INVESTMENT LIMITATIONS

Figures 10 and 11 offer a closer look at the aggregate number of reservations lodged in the eight IIAs as well as their distribution across broad sectors of economic activity. At the same time, these two figures focus on the types of treaty obligations to which the reservations are linked. The two charts show that national treatment limitations (allowing differential treatment on the basis of nationality with a view to favouring domestic over foreign investors) are the most prevalent form of reserved measures affecting investment in both goods- and services-related industries. Among the other leading types of investment-related reservations, the most frequently encountered concern the MFN treatment principle, local presence (i.e. mandated establishment) requirements, as well as restrictions on the movement of key personnel and on the right of establishment.[13] The figures also reveal that market access limitations (i.e. non-discriminatory quantitative restrictions) and performance requirements stand out as the least scheduled measures.

Figure 10 reveals slight differences in the leading types of non-conforming measures affecting investment in goods- and services-related industries. The top three types of investment regulation in services industries are: first national treatment, then local presence requirements and, finally, MFN treatment. For goods-related investment in turn, the ranking of the principal obligations prompting host country governments to lodge reservations is: first, national treatment; second, prohibition of performance requirements; and third, MFN treatment.

**Figure 10. Reservations on investment by type of measure**

US-Chile, NAFTA, Mercosur, G3, Canada-Chile agreements - absolute numbers




| | National treatment | MFN treatment | Performance requirements | Movement of key personnel | Local presence | Right of establishment | Market access | Other / not identified |
|---|---|---|---|---|---|---|---|---|
| Goods | 66 | 25 | 32 | 3 | 9 | 14 | 10 | 23 |
| All sectors | 58 | 34 | 12 | 17 | 10 | 0 | 1 | 20 |
| Services | 376 | 136 | 37 | 82 | 164 | 94 | 41 | 244 |

*Source*: UNCTAD IIA database.

The limited extent of market access barriers would appear to suggest that host countries tend to be less concerned with restrictions on the number of entrants in key industries (i.e. on the level of competition in the home market) than with the conditions under which such competition unfolds in the post-establishment

phase. The heavy reliance on national treatment limitations and other measures favouring domestic over foreign investors suggests a desire by host country governments to help national firms withstand the competitive pressures stemming from foreign (and new) entry. It may also suggest the political sensitivity of sectors considered to be of strategic importance.

The data presented in figure 10 also reveal that limitations placed on the movement of persons are negligible in goods-related industries. However, their incidence is significantly higher in services-related investment, a pattern that is also typical for local presence requirements. Such differences can be attributed to important differences between services and manufacturing activities. In the case of local presence requirements, one must recall the greater regulatory intensity of service sector activities and the corresponding preference of host country regulatory authorities to see foreign firms establish a presence (so as to facilitate – and indeed make possible – the exercise of jurisdictional authority over their operations and ensure that the latter comply with national policy and regulatory objectives).

As regards the movement of key personnel, the limited number of reservations applied to investments in goods-related industries reflects – to some extent – the horizontal manner in which many host countries' immigration and labour market policies are framed and implemented. Possibly, it also highlights the fact that the occupational categories that most likely require temporary entry in manufacturing (intra-company transferees, specialists, managers) typically encounter few obstacles. Amongst others, this might be due to the fact that they are deemed essential to the establishment and operation of a foreign investment and that they typically account for a small fraction of total employment in foreign manufacturing firms (since key personnel from abroad do not usually compete with factory plant workers). This is not true

for FDI in many service sectors, given the higher average level of skills involved, the smaller average size of firms and the greater potential for foreign workers to compete directly with – and possibly displace – skilled local personnel. The latter may explain – to some extent – the relatively high incidence of training-related performance requirements observed in services- industries.

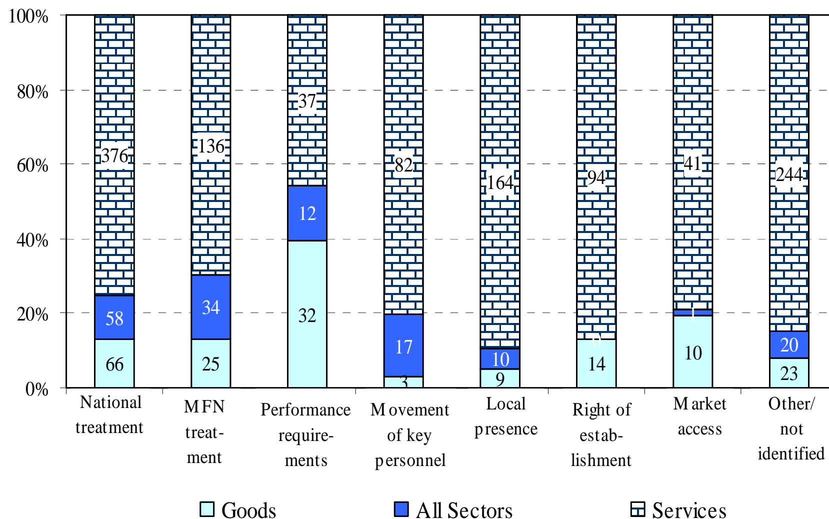
The primacy of services as the main sector of investment-related reservations is clearly visible in figure 11. Two aspects warrant particular attention. First, for services, the prevalence of reservations is highest for measures that mandate a local presence in order to supply host country markets and for measures that restrict or limit the right of foreign investors to establish themselves in host country markets. Second, there is a higher share of performance requirements affecting service industries as opposed to goods-related sectors (primarily manufacturing). While some recent IIAs ban, in principle, the use of performance requirements in both goods- and services-related industries (and hence compel contracting parties to reserve existing non-conforming measures if they wish to maintain them), in the multilateral context, such disciplines currently only apply to investments in goods-related industries under the WTO Agreement on Trade-Related Investment Measures (TRIMs). For the most part, service sector performance requirements relate to training requirements, aimed at enhancing the level and quality of human resources in capital importing countries.

## D. NORTH-SOUTH COMPARISON

As regards the most common types of non-conforming measures reserved by countries according to their level of development, the revealed policy preference of host countries appears broadly similar

**Figure 11. Reservations on investment by type of measure**

US-Chile, NAFTA, Mercosur, G3, Canada-Chile agreements - percentage distribution




*Source*: UNCTAD IIA database.

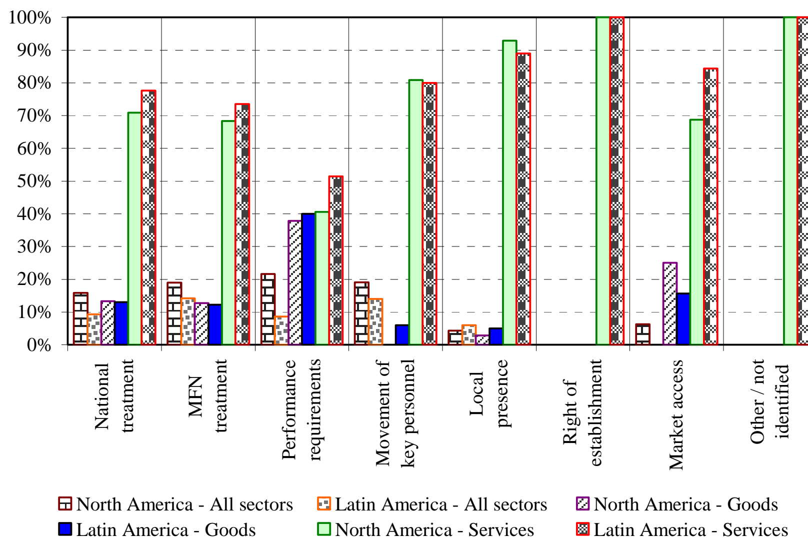
along North-South lines. Such findings emerge from comparing reservation patterns that characterize a subset of developed (Canada and the United States) and developing (Chile, Colombia and Mexico) countries in North and Latin America. Indeed, while some differences along North-South lines can be discerned regarding the sectoral incidence and types of reservations lodged, Figures 12 and 13 reveal remarkably similar reservation patterns between the two country groupings. This trend characterizes investment in both goods- and services-related industries.

The three Latin American countries featured in figures 12 and 13 (the combined size of whose economies is significantly

smaller than that of their two Northern neighbours), nonetheless tend to lodge a greater overall number of reservations, and they do so across all covered sectors. This would appear to reflect a cautious policy stance towards FDI in general and towards service sector liberalization in particular. It may also mirror their greater (perceived) need for flexibility, resulting from infant industry-type concerns in a number of key sectors. Finally, it may reflect the wish to preserve flexibility for future regulatory purposes in areas where they may not yet possess solid or fully developed regulatory frameworks and implementation capacities.

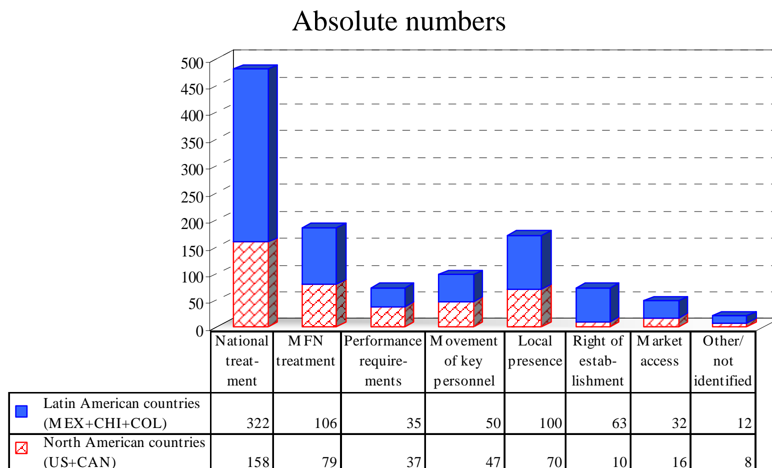
**Figure 12. Reservation by type of measure, sector, and group of countries**

North America = United States, Canada LatinAmerica = Colombia, Chile, Mexico




*Source*: UNCTAD IIA database.

**Figure 13. Reservations by type of measure and group of countries**




| | National treat-ment | MFN treatment | Performance require-ments | Movement of key personnel | Local presence | Right of estab-lishment | Market access | Other/ not identified |
|---|---|---|---|---|---|---|---|---|
| Latin American countries (MEX+CHI+COL) | 322 | 106 | 35 | 50 | 100 | 63 | 32 | 12 |
| North American countries (US+CAN) | 158 | 79 | 37 | 47 | 70 | 10 | 16 | 8 |

*Source*: UNCTAD IIA database.

Reservations may also correspond to internal pressures for continued protection. Such pressures may originate from economic and political constituencies (including foreign affiliates as well as bureaucracies) that may view investment liberalization and the expected rise in competition as a direct threat to their privileged positions. While such pressures may arise in all countries, developing countries may be particularly vulnerable to them, given the higher degree of political and economic concentration that characterizes many of their economies.

The three Latin American countries seem to make greater use of horizontal measures applying to all sectors. In their Northern counterparts, reservations tend to be lodged with greater sector-specificity across goods- and services-related industries. However, the sectors in which such reservations concentrate tend to be broadly similar, with transport, finance, business, and communications services leading the way in both country groupings.

The data in figure 13 confirm national treatment as the policy instrument most commonly used by host country governments to preserve flexibility. In fact, national treatment accounts for some 37 per cent of reservations for North American countries and for 45 per cent of the three Latin American countries' reservations. Performance requirements are the only category, in which Canada and the United States maintain a higher absolute number of reservations than the three Latin American countries.

The finding that North American countries maintain a share of reservations on performance requirements that is greater than that of their Southern counterparts may come as a surprise: in fact, the elimination of performance requirements has traditionally been considered a Northern interest. This is particularly the case of United States' investors, who fought hard for the establishment of the WTO’s TRIMs Agreement during the Uruguay Round. The scope of the TRIMs disciplines is limited to the trade-distorting effects of investment in goods-related activities but no reservations can be lodged under it – unlike IIAs negotiated at the bilateral or regional level.

The trends depicted above are confirmed when looking more closely at chapter XI of NAFTA, which features comprehensive disciplines on both the protection and the liberalization of cross-border investment activity and which links the three economies of Canada, the United States and Mexico, at differing levels of development.

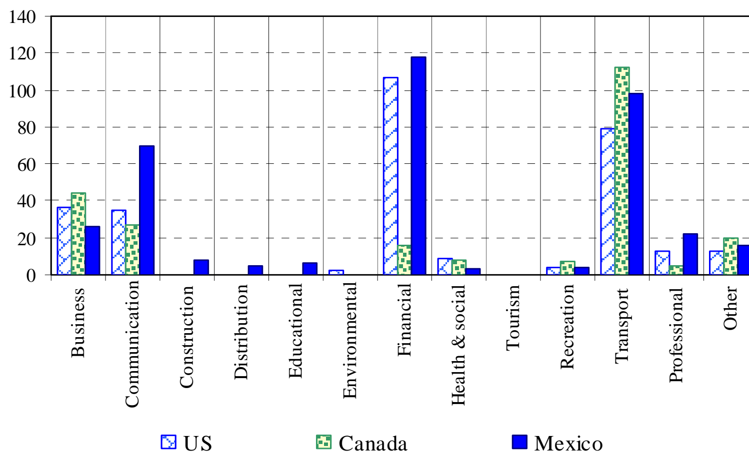
The complex set of reservations as established in NAFTA's investment chapter was described in chapter I of the study. Figure 14 provides a synthetic reading of some of the key features of the non-conforming measures related to foreign investment in services scheduled pursuant to Annex I of the chapter (focusing on existing

non-conforming measures). It shows, once more, that the bulk of non-conforming measures is found in the same four sectors (i.e. transportation, financial, business and communication services). Financial services concerning Canada are an exception. Here, the lower share under NAFTA masks the fact that many non-conforming measures, especially in insurance and securities services, are maintained at the sub-national (i.e. provincial) level.

Figure 14 also confirms the tendency for developing country IIA contracting parties – Mexico in this case – to preserve a greater overall level of flexibility by inscribing a higher absolute number of non-conforming measures than its two developed country partners. This is the case both in overall terms as well as for all but one of the specific industries in which service sector reservations can be lodged, namely recreation services.

**Figure 14. Reservations on investment in services**

NAFTA countries - absolute numbers




*Source*: UNCTAD IIA database.

To sum up, this chapter showed that the overwhelming majority of reservations is found in the services sector, amounting to almost three-quarters of total reservations. This reflects the higher level of regulation at the national level. Reservations in the manufacturing sector are negligible, with a share of just 1 per cent. Limitations on the exploitation of natural resources account for 13 per cent and most of them fall in the areas of fisheries and agriculture. Horizontal measures take the rest, amounting to 15 per cent.

When looking at the sectoral incidence of reservations on services, it is notable that four industries (i.e. transportation, financial, business and communications services) account for 82 per cent of the total limitations. Restrictions on transportation take the lead, with 38 per cent. This is despite the fact that air transport is usually carved out of IIAs. These four sectors also stand out as the most restrictive ones when countries are grouped by income level (i.e. developed/developing). However, their relative importance differs across countries: developing countries tend to lodge more restrictions on communications services and financial services than do developed countries. This tendency is reversed in the case of transport services and business services.

Among the different types of restrictions that countries apply, limitations to national treatment are most frequently used, both by developing and developed countries. Other commonly found restrictions concern MFN treatment, local presence (i.e. mandated establishment), the right of establishment and limitations on the movement of key personnel. Market access limitations and performance requirements stand out as the least scheduled measures.

Limitations on national treatment are the most frequent measures in services and goods; they are also the most frequent among horizontal measures. In services, national treatment limitations are followed in importance by local presence requirements and restrictions to MFN; in goods, these positions are occupied by performance requirements and MFN limitations. Surprisingly, however, a higher absolute number of performance requirements falls on services than on goods-related activities. Limitations on the movement of key personnel fall mostly on services activities, their incidence being negligible in the goods sector.

A North-South comparison limited to the American continent confirms the general finding that reservations from developed and developing countries present similar patterns, but that the latter tend to lodge a greater number of them across all sectors. This seems to reflect the greater need of developing countries for flexibility.

## Notes

[1] See Annex 1 for a short depiction of each agreement's key characteristics.

[2] Venezuela has recently been accepted as a new member. However, the Mercosur membership has not yet become effective.

[3] The non-OECD countries that are parties to the National Treatment instrument are Argentina, Brazil, Chile, Estonia, Israel, Latvia, Lithuania, Romania and Slovenia.

[4] See with regard to this categorisation: Annex 2 - A Word of Methodological Caution.

[5] Indeed, if the share of horizontal reservations is apportioned according to the average share of services- and goods-producing sectors in the GDP of the sample countries, then the aggregate share of service sector reservations stands at 82.2 per cent, while that of goods-related reservations stands at 17.8 per cent. Viewed this way, slightly more than

four out of five non-conforming measures maintained in investment agreements affect services industries.

[6] For a fuller discussion of regulatory intensity in services and its impact on trade and investment activity, see Mattoo and Sauvé 2003.

[7] While environmental reasons are frequently cited as a reason for domestic regulation, few of the reservations reviewed relate directly to environmental concerns. To some extent, this may reflect the fact that the potentially trade- and investment-adverse impacts of environmental regulations tend to be addressed by general exception clauses common to most IIAs. It is also a reflection of the fact that, by and large, environmental regulation is essentially non-discriminatory in nature

[8] The bulk of investment restrictions in fishing consists of: a) limitations or bans on the establishment of foreign companies; and b) limitations on the nationality of the vessels (flagged vessels) that can be registered for fishing purposes.

[9] The liberal regime in international trade and FDI in manufacturing contrasts with the significantly more restrictive situation found in agriculture, where restrictions upon foreign investment are common in reservation lists, taking the form of various deviations from national treatment and restrictions on the acquisition of rural land by foreign individuals or corporate entities.

[10] According to the WTO's Services Sectoral Classification List "business services" include professional services, computer and related services, research and development services, real estate services, rental/leasing services without operators, and other business services. For the purpose of the present study, professional services have been listed separately because of their economic importance.

[11] Cabotage refers to the practice whereby a transport services provider may take on transport services between two points within a foreign country.

[12] The transportation-related measures depicted below are taken from the OECD National Treatment Instrument.

[13] IIAs do not generally allow contracting parties to lodge reservations on investment protection clauses, such as those relating to transfer of funds or guarantees against expropriation. Reservations normally relate to liberalization commitments, which originate in the various economic characteristics of host countries and in the political economy of specific sectors. Protection obligations, in turn, are absolute

in nature and apply across the board to all economic activities. The rationale for excluding certain sectors from investment protection is generally weak, as it would imply that a government may expropriate in selected areas without offering affected foreign investors due compensation. Recent BIT models, particularly those of the United States and Canada, include a provision stating that non-discriminatory regulatory initiatives for legitimate public policy objectives would not constitute an expropriation except in extraordinary circumstances. These provisions, however, do not constitute exceptions to such agreements. Rather, they form part of the agreement, for purposes of clarifying the meaning of key policy aspects (such as the scope of indirect expropriation) as well as for interpretative purposes in the case of an investment dispute.

## CONCLUDING REMARKS

It is the very nature of IIAs to constrain the policy options available at the national level. Despite such constraints, host country governments in developed and developing countries alike have entered into an ever-increasing number of IIAs at the bilateral, regional and interregional levels. To a considerable degree, they have done so because they view IIAs as useful tools for enhancing domestic investment climates, for locking-in recently enacted (and typically liberalizing) policy reforms and for signalling the future direction of their investment policies. While legally binding obligations can indeed prove beneficial for consolidating ongoing reform efforts and for increasing the transparency and predictability of national investment regimes, IIAs have long recognized, in various forms, the need of host countries to preserve flexibility for putting in place national development policies.

Among the key means through which IIAs can satisfy host countries' needs for flexibility is the scope they afford for lodging reservations with a view to maintaining existing (or introducing future) policy measures that do not conform to substantive treaty obligations. The need for flexibility is arguably greatest in developing countries, given prevailing weaknesses in regulatory frameworks and institutions and the task to support the development of indigenous productive capacity in key sectors. Moreover, developing countries do not always have sound and established policies in place, and, therefore, trial-and-error regulatory experimentation may still take place in key (and, usually, heavily regulated) activities. In such cases, precautionary reservations (i.e. those relating to future measures) may be a tool for ensuring that international disciplines do not limit the regulatory flexibility of present and future governments. This in turn should allow them to resort to measures that may prove crucial for a solid and pro-development regulatory framework.

The ability to schedule reservations and to maintain or introduce existing or future non-conforming measures can provide a form of "insurance policy" with regard to host countries' obligations on investment liberalization and protection in IIAs. Making adequate use of reservations may help a host country to reap the benefits potentially associated with liberalized investment conditions and help build domestic support for the nature, level and pace of market opening policies.

The administrative burden that the preparation of reservation lists implies is a matter that can and should be addressed through more capacity building, policy research and technical assistance from capital exporting countries or regional and multilateral agencies. A better understanding of the scope and content of IIAs, as well as of host countries' economic standing, regulatory frameworks and implementation capacities may help developing country officials to discern more precisely the areas where reservations may be desirable and necessary. It may also assist them to identify the types of reservations that are best suited for meeting domestic policy objectives. Longer transition periods for developing countries could be another tool. As one element of special and differential treatment, they may help alleviate some of the difficulties related to the conclusion of IIAs.

This study has focused attention on aggregate trends in the nature and sectoral incidence of reservations lodged by different countries under a sample of important IIAs. It aims to provide a starting point for understanding (by comparing what countries have done in the past) what measures and sectors require particular attention with respect to preserving the necessary flexibility in future IIAs. Data limitations prevented a more refined study of "in-sector" trends in reservation patterns, e.g. to distinguish trends in non-conforming measures in banking and comparing them with results obtaining in insurance or securities services. Future work

could shed further light into the revealed preferences for flexibility on the part of host countries in those key service sectors where the overall incidence of non-conforming measures is most pronounced (i.e. transportation, financial services, telecommunications and professional services).

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# ANNEX 1

## A BRIEF DESCRIPTION OF THE SAMPLE IIAS UNDER REVIEW

**Andean Community (Decision 510)**

The Andean Community Decision 291 establishes the general regime for foreign investments in the Andean countries. It makes no reference to the positive or negative listing of commitments or reservations for non-conforming measures. Indeed, the obligations enshrined in the Decision are general and mandatory. Information on restrictions concerning the establishment and operation of foreign investment in Andean countries is to be found in other legal instruments. Andean Decision 510, entitled *"Adoption of the Inventory of Measures that Restrict Trade in Services"* provides no mandatory disciplines, but annexes countries' lists of services-related investment measures that do not comply with the disciplines on market access and national treatment found in GATS Articles XVI (Market Access) and XVII (National Treatment). While restrictive measures not listed are "automatically liberalized", listed measures are subject to a gradual liberalization process, which is scheduled to be completed in 2005. No such Decision currently exists with respect to foreign investment in goods-related industries. Some references to national preferences in primary and secondary sectors can be obtained from Andean countries' constitutions. Nonetheless, countries may apply restrictions in other sectors than those indicated in their constitutions.

**NAFTA (Chapter XI)**

NAFTA's Chapter XI covers investment activities, except for financial services, which is subject to specific disciplines under a separate chapter (Chapter XIV). Under Chapter XI, MFN and national treatment disciplines apply across-the-board to all covered investments in both the pre- and post-establishment phases of an investment. Subsidies and government incentives are, however, carved out from the scope of the agreement's national treatment

and MFN obligations. Chapter XIV on financial services extends national treatment and MFN rights to investors and their investments in the sector. Under Chapter XI, performance requirements are subject to a comprehensive ban (on the basis of a detailed list of prohibited measures) that focuses on both goods- and services-related requirements (a novelty at the time and a departure from the WTO TRIMs Agreement whose disciplines only apply to investment measures affecting trade in goods). The movement of key personnel, including that related to the establishment and post-establishment operation of an investment, is governed by provisions found in another chapter of the NAFTA (Chapter XVI, entitled "Temporary Entry for Business Persons").

NAFTA was the first major regional trade agreement to follow an elaborated negative list approach to scheduling non-conforming measures (earlier on, such negative list approaches were also adopted in post-war treaties on friendship, commerce and navigation by the United States). Indeed, the Agreement is often cited as the model example of such an approach. As discussed in the study, NAFTA's negative listing technique requires contracting parties to provide a high degree of regulatory detail on the nature of non-conforming measures they wish to maintain or introduce in future. Worthy of mention is the fact that the NAFTA did not generate any lists of non-conforming measures at the sub-national level, an important shortcoming. Though the Agreement initially foresaw the preparation and publication of such lists two years after the Agreement’s entry into force, the Parties ultimately agreed to "grandfather" existing restrictions (i.e. to allow the maintenance of restrictions already in force), without listing them.

**Canada-Chile Free Trade Agreement (Chapter G)**

This agreement was modeled on the NAFTA, following most of its core disciplines and adopting its same broad architecture, including the elaborated scheduling technique used in

NAFTA. The FTA carves out investment in financial services from its main disciplines. However, contrary to the NAFTA, the Canada–Chile FTA does not feature any other chapter addressing financial services. Accordingly, the agreement lists no reservations in financial services, a sector in which a range of non-conforming measures tends to be maintained, as suggested by other IIAs in this sample.

**G-3 (Chapter XII) and the US-Chile Free Trade Agreement (Chapter X)**

Both agreements were based to a large extent on the investment chapter of the NAFTA. As a result, many of the comments applicable to the latter agreement (see above) also pertain to these treaties. However, as regards the lodging of reservations, contracting parties to both agreements agreed to reduce the number of Annexes containing lists of reservations (although the types of non-conforming measures recorded remain broadly identical). Both agreements follow an elaborated negative list approach, generating extensive detail on the nature, type and sectoral incidence of non-conforming measures.

**Mercosur (Colonia Protocol)**

Mercosur's Colonia Protocol on the Promotion and Reciprocal Protection of Investments within Mercosur was signed on 17 January 1994, but it has yet to be ratified by all parties. Accordingly, it has not yet entered into force. Nevertheless, it remains an important agreement for assessing sensitive sectors and measures in the field of foreign investment in a South-South context. The Protocol grants MFN treatment and national treatment to investments of investors of other contracting parties in all economic sectors, in both their pre- and post-establishment phases. Unlike with most other sample IIAs, no sectors are excluded from the scope of the Colonia Protocol, not even highly sensitive or complex ones, such as air transport or energy production. All performance requirements are banned if they relate to (and hence

distort) international trade in goods and services. The agreement features no specific provisions on other issues, such as incentives or quantitative restrictions, which are covered by the Protocol's treatment obligations to the extent that they are discriminatory in character.

As with other IIAs covered in the sample, Mercosur's Colonia Protocol allows the parties to lodge reservations under the different disciplines it establishes. These include: the right of establishment; (post-establishment) national treatment and trade-related performance requirements. Almost all reservations lodged under the Protocol relate to the right of establishment obligation. Unlike NAFTA, the G-3 or the Canada-Chile and US–Chile FTAs, reservations under the Colonia Protocol do not indicate the specific non-conforming measure that the country wishes to maintain. The parties were only required to mention the economic sector where they would apply such a restriction – without giving additional details on the policy measures concerned.

**OECD National Treatment Instrument**

The Third Revised Decision of the OECD Council on National Treatment (OECD National Treatment Instrument) constitutes a legally non-binding plurilateral agreement entirely devoted to the granting of national treatment to established foreign-controlled enterprises. Its only substantial provision is Article 1 (out of 7 articles), which requires the parties to notify the OECD secretariat of all current and future measures that constitute an exception to national treatment. The Instrument does not accord MFN treatment, nor does it provide disciplines on other issues such as performance requirements or quantitative restrictions. Nevertheless, several such measures are covered by the Instrument to the extent that they are discriminatory in nature. The Instrument does not include a right of establishment. This issue is covered by the legally binding OECD Code on Liberalisation of Capital

Movements. Despite the exclusion of the pre-establishment phase, numerous countries have listed discriminatory measures concerning the making of an investment in the National Treatment Instrument.

In following a negative list approach to lodging exceptions, the NT Instrument generally provides (without mandating) a high level of regulatory detail, indicating the legal source of the measure, the type of restriction, and the time period over which the measure is meant to be maintained (when applicable). However, some countries have opted to indicate that certain non-conforming measures may be applied in given sectors, without referring to the legal source of the measure nor to the time period over which it will be maintained, modified or eliminated.

**Draft OECD Multilateral Agreement on Investment (never concluded)**

The draft Multilateral Agreement on Investment (MAI) was negotiated at the OECD among Member countries, the EU and a number of developing country non-Member countries (typically those granted observer status at the OECD at the time). The MAI negotiations were officially called off in December 1998, three years after their launch, owing to the great complexity of the subject, a large number of intractable substantive differences among key parties to the talks and amidst a rising chorus of opposition within the ranks of civil society. At the time when the MAI was abandoned, the text of the proposed agreement was well advanced with regard to its core disciplines and provisions. The draft MAI foresaw that MFN and national treatment obligations would be extended to foreign investments and investors in all economic activities, subject to a few carve-outs (e.g. air transport; public services; intellectual property). The agreement aimed at ensuring entry rights to foreign investors, and ruled out specific performance requirements (both trade- and service-related). It also featured disciplines on the movement of key personnel but stopped

short of extending specific disciplines on the granting of investment incentives, leaving such an issue to future negotiations.

Before the negotiations were called off, the initial reservation lists of prospective contracting parties (solely at the national level in the case of federal states) had been prepared and exchanged. It is not possible to identify precisely which reservations would have remained had the negotiation been brought to a successful conclusion. Still, the draft reservation lists allow a number of inferences to be drawn on the nature and sectoral incidence of sensitive sectors and measures for the purposes of this study.

# ANNEX 2

# HANDLE WITH CARE: A WORD OF METHODOLOGICAL CAUTION

The empirical work conducted in this study consists of recording the number, nature and sectoral incidence of reservations contained in the reservation lists of each contracting party to the eight IIAs under review. The study's main aim is not so much to focus on the aggregate number of reservations found under each agreement – which will naturally vary according to the sectoral scope and substantive provisions found in them – but rather to present major trends and to infer and compare patterns of conduct and the policy preferences these patterns reveal. The conclusions and findings stemming from this analysis should be considered as a first tentative approximation on the issue. They should be regarded with a few additional considerations in mind:

**a) Concerning the countries covered**: although an effort was made to select countries that have signed several negative-list IIAs, the cross-country comparisons found in the study are based on reservations found in a limited sub-sample of agreements (usually 2 or 3). Moreover, some key global players are not represented in the study (e.g. India, China), as they have not signed a considerable number of negative list IIAs.

**b) Concerning the types of measures and the coverage of the agreements:** in order compare the various agreements, a decision was taken to focus solely on agreements operating on the basis of negative lists of non-conforming measures. However, even negative-list agreements may not always be completely alike in their scope and coverage. In particular, it should be borne in mind that:

- Some sectors may be carved-out of an agreement, which may result in the complete absence of reservations in the sector. This is the case, for instance, with investment in financial

services and trade and investment in audio-visual services in the Canada-Chile FTA. It is also the case with much of the air transport sector in several of the IIAs under review;

- Some reservation lists present a lesser level of detail than others, which may hinder the classification of reservations into the most adequate categories. This is notably the case with the Andean countries regarding investment restrictions in the goods sector. To the extent that they stem from constitutional treaty provisions and not from reservations lists appended to investment agreements, such non-conforming measures are described in much more general language and scope;
- Not all agreements under review allow contracting parties to lodge reservations with regard to the same disciplines. For instance, the NAFTA allows reservations to be lodged against nationality requirements applied to the composition of companies' boards of directors, whereas other agreements treat such limitations under national treatment;
- Countries may differ in their interpretations of certain key investment disciplines. For example, certain countries record requirements establishing minimum levels of local equity participation as reservations falling under performance requirements. However, one could also refer to national treatment, market access (quantitative restrictions) and, where relevant, MFN treatment principles when scheduling a reservation to protect legislation on minimum local equity participation. In order to ensure some degree of consistency, whenever performance requirement reservations related to minimum local equity participation and joint venture requirements were found, they were recorded as national treatment and/or MFN reservations. It therefore cannot be excluded that some non-conforming measures were counted more than once (e.g. as reservations on national treatment and MFN treatment). This problem was most acute in the context of the draft MAI, given that reservation lists were produced at

a time when countries were still negotiating the core provisions of the Agreement and were thus unclear on a number of important parameters of scope, definition and coverage. Moreover, MAI data in this study refers solely to reservations scheduled at the national level, as is the case under NAFTA and the Canada-Chile FTA. The absence of information on sub-national measures underestimates the overall importance of non-conforming measures, particularly in services, as these sectors are often subject to extensive regulation at the sub-national level in countries like Canada, the United States and Germany.

**c) Concerning the sectoral classification of reservations**: the classification that has been used for services is based on GATS schedules. It differs in one important respect, however, insofar as the study takes out "Professional Services" from "Business Services" in order to better reflect its particularities and policy sensitivities (and consequent restrictive measures found in the sector).

Other considerations to bear in mind include the following:

- Countries' definitions of particular sectors vary widely. In the draft MAI, for instance, Austria classified a reservation on "tourist guides" as arising in the "business services" sector, while many other countries classified the same type of reservation under "tourism services." In order to ensure a certain degree of consistency across countries, it was occasionally necessary to record reservations in sectors different from those specified by countries;
- A related problem arises when countries lodge reservations that cut across two or more sectors. For example, under the G-3 agreement, Mexico inscribed a reservation in the "Telecommunications and Transport" sector. In such cases, a decision was made to split such reservations into two: one in

the telecommunications sector and the other in the transport sector;

- Disparities may also arise as regards the scope of individual reservations. Under the OECD National Treatment Instrument and the draft MAI, for example, some countries have lodged one reservation covering their entire “professional services” sector. Other countries have lodged separate reservations for legal, auditing, dental, and taxation services. As a result, countries with very similar regimes in a particular sector might have a very different number of reservations in that sector. This underscores the fact that the number of reservations may not fully capture the “restrictiveness” of a particular country’s regulatory regime. For this reason, it is preferable to interpret information in terms of shares (i.e. percentages) and avoid comparing the aggregate number of reservations across countries; two different sorts of instruments where utilized to document Andean country reservations in services- and goods-producing industries. While for the former recourse was made to the Andean Decision 510, countries' restrictions on goods were taken from constitutional treaty provisions. The differing nature of these instruments may influence the actual "weight" of restrictions in each sector. Measures listed under a dedicated regulatory instrument (i.e. Decision 510) typically feature a greater level of detail, and tend to be greater in number.
- Two different sorts of instruments where utilized to document Andean country reservations in services- and goods-producing industries. While for the former recourse was made to the Andean Decision 510, countries' restrictions on goods were taken from constitutional provisions. The differing nature of these instruments may influence the actual "weight" of restrictions in each sector. Measures listed under a specific regulatory instrument (e.g. Decision 510) typically feature a greater level of detail, and tend to be greater in number.

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