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PRESERVING FLEXIBILITY IN IIAs: THE USE OF RESERVATIONS

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EXECUTIVE SUMMARY & INTRODUCTION

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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.