The emerging North American investment regime*

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With the phasing in of the 1994 North American Free Trade Agreement, trade and investment policies in North America have moved far beyond shallow integration limited to the removal or reduction of tariff barriers on goods, into deep integration—the removal or reduction of most barriers to flows of goods, services and investments. At the same time, bilateral harmonization and coordination of other policies, such as taxation and transfer-pricing regulation, are encouraging further integration, with the result that investment and market-access rules in North America are becoming regionalized. A North American Investment Regime is emerging, based on the norm of national treatment, that is foreign activities within a country are treated similar to domestic activities. This article documents the emerging North American investment regime, focusing on the areas of trade, investment and tax policy; it outlines the main characteristics of this regime, and draws some conclusions about problem areas and further policy directions.

Introduction

Within North America, market access and foreign investment rules are becoming regionalized. These regulatory changes have their most tangible

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result in the 1994 North American Free Trade Agreement (NAFTA), but other policies, for example, tax policies, are also changing in ways that promote deeper regional integration. A shift in the overall regulatory environment is occurring in North America, away from unilateral rules to bilateral and trilateral policy-making. This shift can be seen in two ways:

- as a move away from weak/soft international regulation (non-binding commitments at the regional level) towards strong/hard international regulation (binding, formal rules and procedures);

- as a widening of the geographic scope of the regulatory environment from the national to the regional level.

One of the main components of this shift to stronger regional integration in terms of the overall regulatory stance has been NAFTA. Cross-border trade and investment regulations in this agreement have moved far beyond shallow integration, that is, the removal or reduction of tariff barriers on goods that one finds in a simple free trade agreement into deep integration—the removal or reduction of barriers to cross-border flows of goods, services, investment and technology. NAFTA contains extensive binding, formal commitments (i.e. strong international regulation) that require Canada, Mexico and the United States to remove tariff and non-tariff barriers within the region. Even outside NAFTA, deep integration is also occurring through greater harmonization of specific national policies, such as taxation, that impact on the effectiveness of liberalized trade and investment. Underlying these regulatory changes is the extension of the norm of national treatment—foreign activities performed within a country's borders receive the same treatment as activities of nationals—typically found in multilateral trade agreements such as the General Agreement on Tariffs and Trade (GATT), to foreign investment, services and intellectual property.

Why the shift to deep integration? Governments, not only in North America, but also worldwide, are liberalizing their economies, opening their doors to transnational corporations (TNCs), and creating business-government alliances, in the hopes of improving the international competitiveness of their firms and countries (Dunning, 1994; UNCTAD, 1995). Behind these changes in government regulation, both worldwide and within North America, is an implicit view of TNC-State relations as cooperative and positive sum (Agosin and Prieto, 1993; Dunning, 1993a, b; Eden, 1994). Removal of trade and investment barriers encourages firms, particularly TNCs, to allocate their production and sales on a regional basis, making resource-allocation decisions on economic rather than political grounds. Firms are therefore able to achieve economies of scale and scope, taking advantage of the large, barrier-free market to improve their competitive advantage. The more competitive local firms are, the more their activities will be reflected in higher value-added production, exports and employment. Thus, liberalization of trade and investment policies is seen as a way to encourage productive investment and long-run national performance.

The purpose of this article is to document some of these recent policy changes in North America, show how these policy changes illustrate a move towards deep integration, outline some remaining problem areas, and draw some conclusions about further policy directions. It is argued that an international regime in cross-border trade and investment is emerging in North America, organized around three policy areas or "faces": international trade, investment, and tax policies, defined as the North American investment regime. The norm or standard implicit or explicit in each "face" of the North American investment regime is national treatment. Recent changes in each of these policy faces in North America show how a strong and deep investment regime is emerging at the regional level, based on the national treatment standard. In the last part of the article, some problems which continue to hamper the formation of a North American investment regime are outlined, along with some possible solutions that would facilitate deeper integration.

The conclusion points to the fact that the regulatory environment for TNCs in North America is moving in four ways that suggest the formation of an international investment regime. First, deep integration is occurring as trade, investment and tax barriers to cross-border flows are being removed or harmonized among the three NAFTA partners. Second, the regulatory environment is becoming more vigorous in the sense of moving from non-binding commitments to cooperate towards binding, formal rules and procedures that require integration and/or harmonization at the regional level. Third, the geographic scope of the regime is broadening: now trilateral, but perhaps soon extended to Chile, and eventually to all of the Americas (the proposed Free Trade Area of the Americas). Lastly, the international norm around which all of these regulatory changes are coalescing is the national treatment norm.

The global regulatory environment for transnational corporations

At the global level, the regulatory environment for transnational corporations has clearly become more liberal over the past 10 years. To quote John Dunning (1994, p. 24), "most Governments are acclaiming FDI as "good news" after a period of being highly critical—if not downright hostile—to these investments in the 1970s and early 1980s".

The rationale for this liberalization of FDI regulations is the view that TNCs contribute to the economic performance of countries, and that, in the long run, host economies are better off if they facilitate the international production and investment activities of TNCs than if they attempt to block this integration. The *1995 World Investment Report* clearly enunciates this perspective:

> "Foreign direct investment (FDI) by transnational corporations (TNCs) now plays a major role in linking many national economies, building an integrated international production system—the productive core of the globalizing world economy. Transnational corporations deploy their tangible and intangible assets . . . with a view towards increasing their competitiveness and profitability. At the same time, the deployment of these assets by firms strengthens the resource base of countries and their capacities to produce, to reach and expand markets for their products, and to restructure their economies—in brief, to improve their overall economic performance." (UNCTAD, 1995, p. xix)

Evidence of this trend towards liberalization of the rules governing TNCs is everywhere.

- First, national laws governing inward FDI have become less restrictive. The same *World Investment Report* states that 101 of 102 new legislative measures regarding FDI that were adopted by 57 countries in 1993 were liberalizing and/or promoting FDI, as were 108 out of 110 measures adopted by 49 countries in 1994. In general, the report characterizes inward FDI regimes as broadly liberal, and becoming increasingly open and similar as governments attempt to attract competitiveness-enhancing FDI (UNCTAD, 1995, p. 272).

- Second, few regulatory measures restrict outward FDI flows; foreign exchange controls have been lifted in most countries, although a number of developing countries have retained them for balance-of-payments reasons.

- Third, bilateral and multilateral treaties and conventions are increasingly being used to harmonize national regulations and to establish international standards or norms of conduct (Dunning, 1993, chap. 21; Graham, 1994, 1995; Kline, 1993; UNCTAD, 1995). Bilateral investment treaties (BITs) are expanding, offering national treatment and right of establishment, outlawing performance requirements and expropriation. Bilateral investment treaties facilitate FDI and signal the host country as a good location for investment.

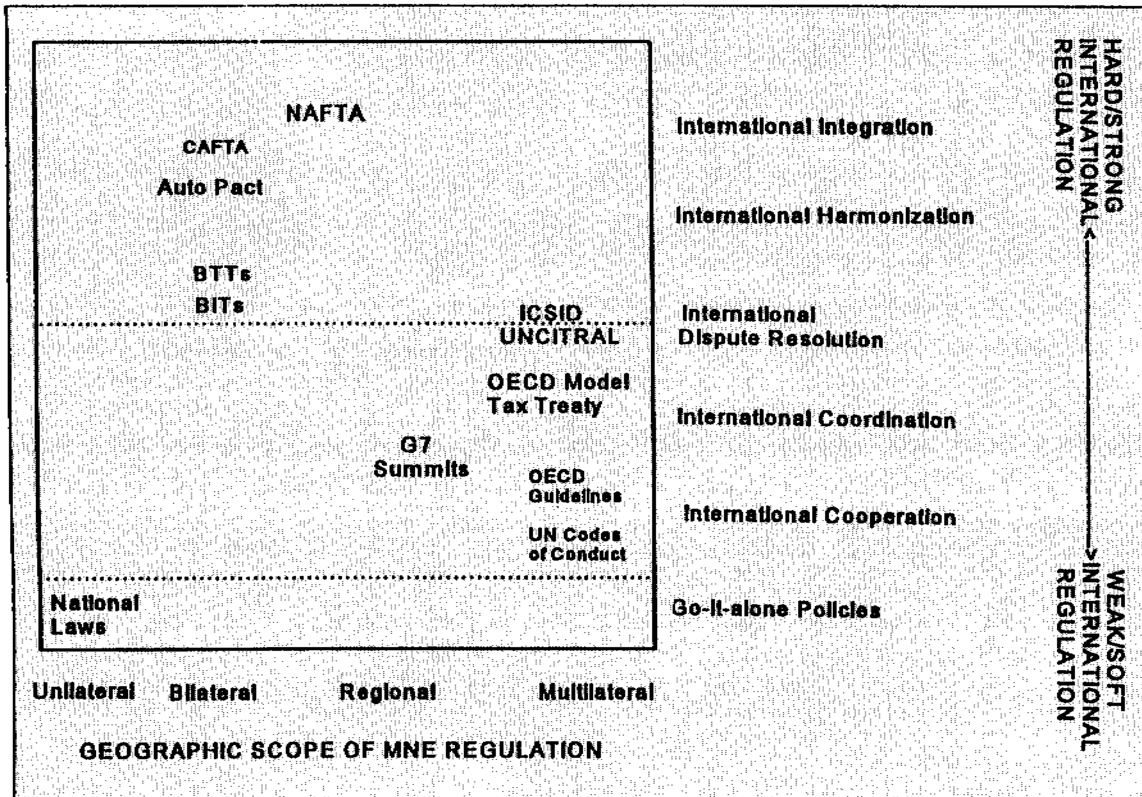
Bilateral tax treaties are used to coordinate taxation by the home and host countries of income from FDI, with the goals of preventing tax evasion by TNCs, avoiding double taxation of TNC income, and ensuring an equitable distribution of tax revenues among national governments. The number of these treaties is growing very quickly; the *1995 Worldwide Tax Treaty Index* records more than 2,800 treaties, protocols and bilateral tax documents from 181 countries (Tax Analysts, 1995).

In addition, new regional integration schemes, such as MERCOSUR, have been formed, while old schemes, such as CARICOM, are being revitalized and expanded. Trade agreements tend to focus on the removal of tariffs and non-tariff barriers that discourage cross-border trade in goods. Thus their impact on TNCs is indirect, running from the impact of the regulations of trade in goods to production decisions and then to investment decisions. Even in the Uruguay Round, the explicit connection to FDI is through TRIMs (trade-related investment measures) rather than through FDI regulations directly since the agreement did not cover investment *per se*.

The changes in the global regulatory environment for TNCs can be shown by modelling international regulatory approaches in a two-dimensional space (fig. 1).

First, regulations/policies affecting TNCs can be made at various levels: unilateral, bilateral, regional, multilateral. The horizontal axis in figure 1 therefore represents the geographic scope of international economic integration. Second, let the vertical axis represent the degree of international regulation, ranging from weak/soft approaches to strong/hard approaches to

Figure 1. The Regulatory Environment for Transnational Corporations in North America



international regulation of TNCs. Building on John Kline (1993), one can classify government policies under one of six categories that move from weak to strong approaches to international regulation:[1]

- *Go-it-alone policies*: government policies that are set for domestic reasons, regardless of their impact on other countries, e.g. unilateral devaluation of a currency, the reduction or increase in a tax rate, the unilateral change in FDI regulation. If all governments engaged in unilateral regulation, no international regulation would exist.

- *International cooperation*: policies that facilitate cooperation among countries but require no binding commitments, e.g. voluntary codes of conduct outlining good behaviour norms for TNCs and the OECD model tax treaty.

- *International coordination*: policies that facilitate policy coordination among countries, e.g. the Group of 7 commitments to coordinate monetary policies.

- *International dispute resolution*: policies to resolve international disputes, e.g. the Competent Authority provisions in bilateral tax treaties, international arbitration, and binational panels under NAFTA. Dispute-resolution methods that are binding on the parties are harder/stronger approaches than those that are non-binding.

- *International harmonization*: the harmonization[2] of standards and policies around a common benchmark or minimum standard; e.g. the European Union process of standardization within the single market framework, the harmonization of customs procedures and mutual recognition of professional qualifications. These commitments are formalized in rules that are binding on the parties.

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[1] The classification is based on Kline (1993). However, in his framework, the distinction between soft and hard depends on whether the policies are non-binding or binding. Thus national laws are hard policies because they are binding instruments. The present framework includes this component but focuses only on the international aspects of regulation; i.e. whether the parties go it alone with unilateral policy moves (no international regulation), cooperate or coordinate their policies (weak international regulation), or harmonize or integrate their policies (strong international regulation).

[2] Harmonization, following the European Community Treaty of Rome definition, is "making identical or minimizing the differences between standards or related measures of similar scope" (cited in Easson, 1995, p. 123).

- *International integration*: policies that require the removal of barriers to the free movement of goods, services, factors of production, and intangibles across borders, e.g. creation of a free trade area, elimination of screening agencies and establishment of a common external tariff.

Thus, figure 1 shows the range of regulatory approaches facing TNCs, in terms of the strength of the regulatory framework imbedded in the policies (ranging from weak/soft to strong/hard), and the geographic scope of the policies (from national to global). Multilateral measures (such as the proposed United Nations Code of Conduct for Transnational Corporations) offer voluntary models of international cooperation, and as such represent a weak form of international regulation. On the other hand, NAFTA is a strong form of regulation because it contains binding, formal commitments on the NAFTA parties.

The trend to liberalized FDI regulations is primarily occurring through go-it-alone policies and bilateral investment and tax treaties. No coherent, global investment regime, designed to guide TNC-State relations and firm-investment decisions, has emerged to parallel the twin pillars of the GATT international trading regime and the IMF/World Bank financial and monetary regimes. Thus, the regulatory environment for TNCs at the global level remains fragmented and piecemeal (Kline, 1993). The *World Investment Report 1995* suggests that this situation is likely to change (UNCTAD, 1995; UNCTAD, 1996).

> "In fact, given the growing importance of FDI and international production for linking national economies and improving national economic performance, and given the transnational nature of this investment, it is almost unavoidable that a framework will be sought that provides for stability, predictability and transparency at the multilateral level, to allow firms to contribute to economic growth, while prospering internationally."

And, indeed, there is movement in this direction, led by OECD, to adopt a Multilateral Agreement on Investment (MAI) (Sauvé and Schwanen, 1996; UNCTAD, 1996). In 1995, the OECD countries began negotiations on MAI; another meeting is to take place in early 1997. The movement towards international regulation of FDI, however, has been very slow so it is not clear whether the negotiations will be successful.

The regulatory environment for transnational corporations in North America

Even if a multilateral framework for regulating FDI does not exist, at the regional level within North America, however, a new and more cohesive regulatory environment is being formed around NAFTA (Eden, 1994, 1995 and 1996). The general liberalization trend is also evident in North America as each of the three countries has relaxed its trade and investment rules, and bilateral and trilateral trade agreements have been used to further deepen the liberalization process. Regional integration in North America is occurring for the reasons cited by UNCTAD (1995): the desires of governments to remove intra-continental barriers to the flow of goods, services, intangibles, capital and people, based on the belief that integrated interregional production by TNCs will contribute to long-run competitiveness and economic growth.

The regulatory environment: trade, investment and tax policies

Annex 1 provides a list of the trade, investment and tax policies in North America which affect TNCs either directly through their impact on FDI or indirectly through their effects on the intra-continental flow of goods, services, factors and intangibles. This list is not exhaustive, but is meant to suggest the size and shape of the regulatory environment.

A close scan of this list shows that the regulatory environment facing TNCs in North America is a blend of regulatory approaches with differing geographic scopes. For example, trade policies—market access for trade in goods—are determined by national governments, but are also subject to bilateral rules (the Canada-United States Free Trade Agreement or CAFTA), trilateral rules (NAFTA) and multilateral rules (GATT and the World Trade Organization). Investment policies, historically a domestic prerogative, moderated by bilateral investment treaties (BITs), are now regulated by the CAFTA and NAFTA. Trade in services and intellectual property, which are grouped here under investment policies due to their close connection to investment,[3] have also moved from unilateral to regional regulation under NAFTA. Tax policies are set domestically but are coordinated through bilat-

[3] Trade in services generally requires FDI for effective market access; similarly, most technology is produced and traded by TNCs.

eral tax treaties, and follow principles laid down by OECD in its Model Tax Convention. Over time there was a movement away from unilateral regulation of TNCs in the areas of trade, investment and taxation, towards North American standards or norms, primarily through the integrative impacts of NAFTA.

As figure 1 shows, TNCs face a wide variety of regulatory approaches in both vertical and horizontal dimensions. Historically, most policies affecting inward and outward FDI in North America were unilateral policies. For example, the establishment in 1974 of the Foreign Investment Review Agency and the launching in 1982 of the National Energy Program were designed to discourage inward FDI from the United States. Both programmes have since been dismantled. In 1988, the United States Exon-Florio amendment establishing the Committee on Foreign Investment in the United States allows the President to restrict inward FDI on national security grounds (Graham and Krugman, 1992). Mexico's history is replete with decrees restricting inward FDI in key sectors such as automobiles and petroleum, enforcing performance requirements, and requiring trade balancing. Most of these restrictions were reduced or eliminated in the late 1980s.

Approaches tend to be weaker/softer at the multilateral level than at the bilateral or regional levels, with regulation of FDI focused more on encouraging cooperative behaviour among nation States and good behaviour by TNCs (e.g. codes of conduct). At the bilateral level, Canada-United States policy approaches affecting TNCs have been strongly integrative.[4] Bilateral integration between Mexico and the United States is rarer and more recent (the 1992 US-Mexico tax treaty; although coordination of the United States 806/807 tariff rebate programme and the Mexican *maquiladora* programme in the late 1960s should be mentioned), and that between Canada and Mexico even more so (the 1991 Canada-Mexico tax treaty). The key change in the TNC regulatory environment has been the trilateralization of the Canada-United States Free Trade Agreement, bringing Mexico into NAFTA.

An emerging North American investment regime?

Clearly, the regulatory approaches documented above show a movement towards harder/stronger policies based on regional economic integra-

[4] The 1965 Auto Pact, the 1989 CAFTA, the 1980 tax treaty and 1995 tax protocol.

tion in North America. The combination of these regional policies constitutes much more than a simple free trade area where countries eliminate or reduce tariffs on goods traded among themselves. There is no term for an integration arrangement which moves well beyond free trade in goods into areas such as free flows of services and investment, but which stops short of adopting a common external tariff (as in a customs union) or allowing free migration of people (as in a common market). Since the purpose of these policy changes is to provide a level playing-field across North America for TNCs, these changes may be indicated by the emergence of a *North American investment regime*.

International regimes are sets of functional and behavioural relationships among national governments in particular issue areas of the global political economy (Krasner, 1983; Preston and Windsor, 1993). These relationships embody the principles underlying the regime, the expected behaviour patterns (standards or norms) associated with the regime, and the formal arrangements (rules and procedures) that implement the international agreements and understandings that form the regime. Thus regimes are a way to manage interdependencies among nations. When a clear legal framework establishing property rights and liability is missing, markets for information are imperfect, and/or incentives exist for actors to behave opportunistically, regimes can improve the functioning of international markets. International regimes can increase the predictability of behaviour, provide generalized sets of rules, and improve the information available to participants.

The North American investment regime is being created by the three national governments to facilitate their national and joint economic performance. In this emerging regime, the three national governments are cooperating to develop certain principles, norms, rules and procedures designed to reduce conflicts between TNCs and States, facilitate smoother integration of the three economies, and increase the pace of economic growth.

The basic norm or standard that underlies the North American investment regime is *national treatment*. "National treatment" means that a country treats foreign activities performed within its borders the same as it treats domestic activities; both are provided with the same treatment. Foreign goods, services and investments must be treated the same as domestic goods, services and investments, once they have cleared customs and become part of a country's internal market. National treatment allows each member country to apply its own laws within its own borders according to its own objectives. The norm also ensures that nationality does not affect government policy since it ensures that "*mi casa es su casa* (my house is your house)".[5] The next section will show how each of the "faces" of deep integration reflect the national treatment norm.

The faces of deep integration in North America

As annex 1 and the upper right hand quadrant in figure 1 show, the North American investment regime is emerging primarily through intergovernmental cooperation in three areas:

- *Trade policy*: the removal of tariff and non-tariff barriers to the free flow of goods, services, technology and capital within North America through NAFTA;
- *Investment policy*: the application of national treatment to foreign investors and investments, once done through BITs, but now regulated through NAFTA; and
- *Tax policy*: the harmonization of national tax policies through BTTs and NAFTA article 2103.

The first face of deep integration: trade policy[6]

NAFTA, which became law in Canada, the United States and Mexico on 1 January 1994, will remove most trade barriers between the three countries over the next 15 years, as all tariffs and most non-tariff barriers among Canada, the United States and Mexico are either eliminated or harmonized. NAFTA builds on, and in most instances supersedes, the 1989 Canada-United States Free Trade Agreement (CAFTA).[7] Both CAFTA and NAFTA

[5] National treatment is therefore less damaging to a country's sovereignty than the norm of *mutual recognition* (each country must accept products that meet the other country's standards). "I'll accept yours if you accept mine" means that activities within the same market may meet different standards depending on where the products originated.

[6] See Eden (1994, 1995, 1996), Gestrin and Rugman (1993, 1994), Graham and Wilkie (1994), Hufbauer and Schott (1993), Chortle (1994), Lipsey *et al.* (1994) and Rugman and Gestrin (1995).

[7] In some instances (for example, tariff schedules and energy trade between Canada and the United States), NAFTA simply confirms that CAFTA will continue to apply, or apply with minor changes. If NAFTA were ever cancelled, CAFTA would probably continue to apply to United States-Canada trade and investment flows.

provide national treatment for goods from member countries under the terms of GATT (Lipsey *et al.*, 1994, p. 160).

Regional integration schemes have been characterized as shallow or deep integration (UNCTAD, 1993, 1995). Shallow integration involves the removal of barriers to trade in goods; i.e. the formation of a free trade agreement or a customs union.[8] Deep integration, on the other hand, involves the removal of internal barriers that discourage the efficient allocation of international production within the region. This includes elimination of barriers to trade in business services, right of establishment and fair treatment for FDI, and protection of intellectual property. Shallow integration is often government-led, but deep integration is driven by the desire of TNCs to improve their competitive position within the regional market. Removal of internal barriers facilitates the exploitation of economies of scale and scope at a regional level through the siting of plants where they are most efficiently located.

Where is NAFTA in this process? NAFTA is more than a free trade agreement because it goes well beyond eliminating tariff barriers among its members. The upper left-hand quadrant in table 1 shows the core of NAFTA: *market access*, the removal of tariff barriers and the creation of trade-remedy laws. These are the components of any free trade agreement. However, NAFTA member countries retained their right to set different external tariffs, so NAFTA is not a customs union.[9]

NAFTA is a deep integration scheme because it goes well beyond market access for goods (table 1). NAFTA covers cross-border trade in business services, factor mobility and protection of factor owner's rights (e.g. to intellectual property and capital). NAFTA creates a common market for goods, services and factors within the region, while leaving each country free to adopt its own external tariff barriers and fiscal policies. As such,

[8] The key difference between the two is that a free trade agreement allows each member country to maintain its own tariffs *vis-à-vis* non-member countries; whereas a customs union requires the parties to have a common external tariff for imports from non-members. To prevent importers from choosing entry into the country with the lowest tariff barriers, free trade agreements substitute rules of origin, usually based on changes in tariff classifications and/or minimum regional content rules, to prove that cross-border trade has sufficient local content to qualify for duty-free treatment within the free trade agreement.

[9] However, a common external tariff was adopted for computer equipment. Free trade agreements encourage reduction in individual external tariffs also as countries want to avoid disadvantaging their domestic producers by levying higher tariffs on inputs than in other member countries; e.g. Canada has moved its automobile parts tariffs closer to tariff levels in the United States.

Table 1. Deep Integration in the NAFTA

SHALLOW INTEGRATION MEASURES	EXEMPTIONS/ DEROGATIONS FROM NATIONAL TREATMENT
Trade in Goods	**21. Exceptions**
1. Commitments to GATT	21.01. General exceptions
3. Market access annexes: automobiles & textiles	21.02. National security
4. Rules of origin	21.03. Taxation
5. Customs procedures	21.04. Balance of payments
7. Agriculture & sanitary/phytosanitary measures	21.05. Disclosure of information
8. Emergency action	21.06. Cultural industries
9. Standards-related measures	**Annexes I-VII**
10. Government procurement	Reservations and Exceptions to Investment, Cross-border Trade in Services, and Financial Services:
19. Countervailing & antidumping duties	A1. Existing measures & liberalization commitments
20. Dispute-settlement procedures	A2. Reservations for future measures
Side Agreement #3: snap-back tariffs	A3. Activities reserved to the State
DEEP INTEGRATION MEASURES	A4. Exceptions from MFN
Trade in Factors: Capital	A5. Quantitative restrictions
11. Investment	A6. Miscellaneous commitments
15. Competition policy	A7. Reservations, specific commitments and other items
Trade in Services	
12. Cross-border trade in services	
13. Telecommunications	
14. Financial services	
Trade in Factors: Technology	
17. Intellectual property	
Trade in Factors: Labour	
16. Temporary entry for business persons	
Side Agreement #1: labour standards	
Trade in Factors: Land	
6. Energy and basic petrochemicals	
1.04. Environmental commitments	
Side Agreement #2: environmental accord	

NAFTA combines some of the elements of a free trade agreement and a common market, but without a common external tariff. NAFTA is a hybrid: neither fish (free trade agreement, customs union) nor fowl (common market).

Table 2. National Treatment (NT) in NAFTA

- Article 301: Parties grant each other's goods NT under the terms of GATT.
- Article 904: NT applies to standards-related measures; a party must apply the same standards to products from other NAFTA countries that it applies to its own products.
- Article 1003: For contracts covered by NAFTA's government procurement provisions, governments cannot accord goods or services suppliers of another NAFTA country treatment less favourable than received by other suppliers, including its own nationals.
- Article 1102: NT applies, in like circumstances, to the establishment, acquisition, expansion, management, conduct, operation, and sale and other disposition of investments (with noted exceptions).
- Article 1202: Each party shall accord to service providers of another party treatment no less favourable than that it accords, in like circumstances, to its own service providers (with noted exceptions).
- Article 1405: NT applies, in like circumstances, to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of financial institutions and investments in financial institutions in its territory.
- Article 1703: NT applies to the protection and enforcement of all intellectual property rights (except sound recordings where treatment is reciprocal).

Source: Adapted from Lipsey, Schwanen and Wonnacott (1995: p. 160).

NAFTA can be called a ''regional production area'' since it facilitates production sharing by TNCs at the regional level; that is, NAFTA encourages TNCs to make their configuration and coordination decision with the whole North American continent in mind. The norm or standard that underlies NAFTA is *national treatment*.[10] Some of the commitments to national treatment in NAFTA are outlined in table 2. The basic commitment is to market opening, article 301: each party grants the other party's goods national treatment under the same terms as the General Agreement on Tariffs and Trade (GATT). However, GATT's national treatment commitments apply primarily to trade in goods since GATT does not deal directly with investment (Jackson, 1989). NAFTA's commitments, on the other hand, go well beyond what was negotiated in the Uruguay Round, to include investment and business services, items currently on the agenda for the new World Trade Organization.

NAFTA's focus is broader than free trade. In fact, the real focus is interregional investment and production by TNCs (UNCTAD, 1994) in

[10] Eden (forthcoming) argues that transfer pricing rules are also being harmonized within North America, based on the concept of the arm's length standard. Mexico has recently adopted such rules, and is now applying them to all firms, including *maquiladoras*, in Mexico (McLees *et al.*, 1995).

North America. In a regional production area, businesses are free to invest throughout the region, unhampered by tariffs and non-tariff barriers, and protected by national treatment norms. NAFTA ensures that TNCs can have effective market access or presence in the other member countries' markets by guaranteeing investments and investors national treatment throughout North America.

Of course, the creation of a regional production area will not happen overnight, and may only exist on paper. The list of exceptions and annexes presented in table 1 suggests that effective market access throughout North America would require significantly more integration than current commitments promise. Tariff barriers within North America are only slowly being eliminated; it will be 15 years before zero tariffs take effect in some industries. Some non-tariff barriers have been grandfathered, others only reduced, and there are "carve-outs" that NAFTA does not cover, such as culture. Lastly, the rules-of-origin tests (e.g. in automobiles and textiles) could become a significant non-tariff barrier, inducing firms to locate in the largest country (the United States) in order to avoid the tests.

The second face of deep integration: investment policy

Before CAFTA, investment policies in North America were determined by national governments, based on national prerogatives, and often changed without consultation. Where disputes arose (e.g. Canadian complaints about United States extraterritoriality, United States complaints about the Canadian National Energy Program and the Foreign Investment Review Agency), the disputes often simmered slowly for a long time. CAFTA and NAFTA changed this by establishing regional rules for investment.

Under CAFTA, national treatment is guaranteed for investors and investments in North America (Gestrin and Rugman, 1994; Graham, 1994; Graham and Wilkie, 1994; Kudrle, 1994). In effect, CAFTA and NAFTA have replaced the bilateral investment treaties that are so common elsewhere in the world. Chapter 16 of CAFTA, dealing with investment, required Canada and the United States to treat each other's investors in the same manner as domestic investors. These investment commitments were extended in NAFTA chapter 11 to cover *national treatment* (NAFTA partners must be treated at least as well as domestic investors) together with *most-*

favoured-nation (MFN) treatment (NAFTA investors must be treated at least as well as any foreign investor) for all North American investments and investors, including firms controlled by non-North Americans.

Compared to CAFTA, NAFTA introduces an MFN article, and a requirement that investors of another party be awarded the better of national treatment or MFN (NAFTA art. 1104). The national treatment and MFN rules now apply generally (except for measures and sectors that are specifically listed), whereas in CAFTA, the basic national treatment rules only applied to new non-conforming measures. NAFTA also defines "investors" and "investments" more broadly than CAFTA, e.g. foreign portfolio investment is covered as well as FDI. Full NAFTA rights are accorded to outside investors as long as they have substantial business activities in one of the three countries (art. 1113.2). In sum, the broad protection for member country investors and investments is unprecedented in a trade agreement.

Several provisions in NAFTA move beyond national treatment either by establishing common norms for the treatment of FDI or the adoption of measures based not on national treatment but on reciprocity. For example, article 1105 (minimum standard of treatment), commits the parties to a common minimum norm based on "fair and equitable treatment and full protection and security". Reciprocity is the norm in the "tit-for-tat" reservations to investment and services listed in the annexes (table 1).

CAFTA also outlawed the introduction of certain measures designed to discourage the free flow of capital between Canada and the United States. Export and production-based performance requirements, such as those the Foreign Investment Review Agency used to require for new entry, were disallowed. Investment Canada's function as a screening agency was severely curtailed. NAFTA extends the list of proscribed performance requirements and mandates that most existing requirements be phased out over ten years. Trade balancing, local content requirements, technology and exclusive supplier arrangements are prohibited; however, governments can continue to give incentives conditional upon a requirement to "locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development (art. 1106.3). NAFTA forbids restrictions on capital movements, including all types of payments and profit remittances, except for balance-of-payments reasons. Expropriation is outlawed, except for a public purpose and on a non-discriminatory basis, and full and prompt payment of fair compensation is required.

A new investor-State dispute-settlement mechanism is also introduced in section B of chapter 11. Investors can seek binding arbitration for violations of NAFTA obligations, using either the World Bank's International Centre for Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL). The mechanism establishes the conditions under which an investor can take a NAFTA member State to arbitration, the constitution of an arbitration tribunal, the forms of compensation that can be awarded, and exclusions from the mechanism (i.e. FDI decisions made by investment-review agencies in either Canada or Mexico). The mechanism is binding on member States and based on international law, so it goes well beyond the national treatment norm to institute a legal and binding (i.e. hard/strong) form of regional integration in a trilateral dispute-settlement mechanism.

CAFTA grandfathered all measures and laws that were contrary to the national treatment norm but were in effect prior to 1989. In NAFTA, however, grandfathering was replaced with negative lists placed in the annexes to the agreement. These lists exclude sensitive industries from the commitments made in the investment, cross-border trade in services and financial services chapters. The Mexican reservations are much longer than those of Canada or the United States, reflecting the more liberal FDI regimes in the two developed countries, and the Mexican commitment to keeping certain key sectors closed to FDI (e.g. petroleum). The States and provinces were also given two years to provide a list of their exemptions.

In sum, NAFTA extends the protection for investment and effective market access achieved through the various multilateral rounds of GATT. The investment and services chapters of NAFTA contain all the commitments that one would expect in an investment code (Graham, 1994): the norms of transparency, right of establishment, national treatment, dispute settlement, full and fair compensation for expropriation, and removal of performance requirements. As Edward M. Graham (1994) argues, the investment provisions in NAFTA can be a benchmark or model for investment codes at other multilateral or regional (e.g. Asia-Pacific) levels.

Thus NAFTA suggests that regional trading agreements among small groups of like-minded States can be an effective way of deepening integration. As will be seen in the next section, the Agreement has also been a catalyst for regional integration of the corporate income-tax systems in the three countries.

The third face of deep integration: tax policy [11]

With CAFTA and NAFTA eliminating trade barriers and providing a "level playing-field" for FDI in North America, differences in corporate income-tax policies can become more important as a determinant of cross-border intra-firm trade and FDI flows, and can lead to more TNC-State disputes (Eden, forthcoming; Vernon, 1994). Corporate tax burdens vary between countries because of differences in tax rates (e.g. what is the statutory rate and does it rise as the tax base increases?) and differences in tax bases (e.g. what types of income are taxable and at what rates? what costs are deductible and using what methods? how are intra-firm transactions priced for tax purposes? how losses are treated?). In addition, corporate dividends paid to shareholders are taxed twice, once at the corporate level and again at the shareholder level, in some countries (e.g. the United States) while other countries (e.g. Canada and Mexico) have imputation systems that attempt to eliminate this double taxation.

Lastly, TNCs are taxed differently from domestic firms (Eden, 1996). Normally, governments tax the worldwide income of residents and the domestic income of foreign-owned firms. When TNCs repatriate income from a host country, the host government may, in addition to the corporate income tax, levy withholding taxes at varying rates on these outflows. Foreign source income, when repatriated to the home country, may or may not be taxable by the home government. If taxed, the corporate income and withholding taxes paid to the host government may or may not be allowed either as credits or deductions against any additional home country tax. While some harmonization of statutory corporate income tax rates has occurred in North America since the mid-1980s, marginal effective tax rates continue to differ (Eden, 1996; Mintz and Tsiopoulos, 1993).

While the need for tax harmonization has been recognized by policy makers in the three countries, the primary way this need has been addressed so far is not through harmonization of tax rates or tax bases but through (1) bilateral tax treaties and (2) article 2103 of NAFTA. Each is examined below.

[11] Parts of this section are drawn from Eden (1995).

Deep integration through bilateral tax treaties

The purpose of a bilateral tax treaty is to reconcile a domestic tax system with the systems of a country's major trading and investing partners, through bilateral coordination of two tax authorities. A tax treaty is a comprehensive set of rules defining the tax liabilities of international investors that specifies each country's rights to tax foreign source income and the income of non-residents of the other country (Brean, 1984, p. 10; Pagan and Wilkie, 1993, chap. 9). The goals are to avoid overlapping tax jurisdictions, prevent double taxation, or undertaxation, of international income, and ensure a fair and equitable distribution of income between the home and host countries.

Tax treaties normally commit the parties to non-discriminatory tax treatment between domestic and foreign investors, include an exchange-of-information article, establish a dispute-settlement mechanism (the Mutual Agreement Procedure whereby the two Competent Authorities meet to resolve bilateral tax disputes), and determine withholding rates levied on outflows of non-resident income. No two tax treaties are alike since they are specifically negotiated so as to deal with the interactions of two domestic tax systems; however, most treaties follow the general principles outlined in the 1977 or 1992 OECD Model Income Tax Convention (depending on the age of the bilateral tax treaties). Generally, the negotiation of a tax treaty takes several years as the two countries attempt to coordinate their taxation of foreign income and negotiate mutual reductions in withholding tax rates.[12]

Canada and the United States have had a tax treaty in place since 1936; however, Mexico did not have treaties with either Canada or the United States until the late 1980s. The prospect of NAFTA was one of the factors that led Mexico to seek bilateral tax treaties with Canada and the United States, as one way to encourage inward FDI (i.e. by providing a more secure and similar tax regime for foreign investors). Table 3 provides some information on the national treatment commitments in the current bilateral tax treaties among NAFTA member countries.

[12] This latter point illustrates the conditional reciprocity embedded in BTTs. Each country reduces its withholding rates conditional on the other country's reduction, and benefits of lower withholding-tax rates are not shared with other treaty partners since each treaty is bilateral (i.e. MFN does not apply). Thus BTTs are similar to the early one-on-one negotiations under GATT.

Table 3. National Treatment in the North American Bilateral Tax Treaties

	1995 Canada-US Tax Protocol	1991 Canada-Mexico Tax Treaty	1992 US-Mexico Tax Treaty and Protocols
National Treatment and MFN Norms:			
National Treatment	(1) The tax on non-nationals shall be no more burdensome than that levied on nationals in the same circumstances. (2) The tax on a permanent establishment shall be no less favourable than that levied on residents carrying on the same activities.		
National Treatment for NAFTA investors			A resident of a State that is a NAFTA party may qualify for treaty benefits in certain circumstances (e.g. 51/49 joint ventures).
Unrestricted Most Favoured Nation (MFN)		The tax on a company owned or controlled by residents of the treaty partner shall be no more burdensome than that levied on companies owned or controlled by residents of a third country.	
Restricted MFN		If Mexico signs a treaty with an OECD State setting a withholding tax on interest or royalties below 15 per cent, Mexico grants Canada the lower rate, but not below 10 per cent.	If the US signs a treaty with a third country that provides a lower withholding rate on direct dividends, both parties shall apply the lower rate (protocol).

The 1995 Canada-United States tax protocol

The 1980 Canada-United States tax treaty, amended by protocols in 1983, 1984, 1994 and 1995, came into effect on 1 January 1985.[13] The treaty provided non-discriminatory tax treatment for foreign investors, but only in

[13] The provision of tax protocols is standard OECD practice.

terms of the corporate income tax. An exchange-of-information clause allowed the two Governments to exchange information on income, estate and gift taxes. Competent authority provisions were established so that tax disputes, e.g. in the transfer pricing area, could be brought to the table by one government (not by an investor) and settled bilaterally. However, the tax authorities were not required to reach agreement, nor to provide offsetting tax adjustments, so that double taxation could still occur.

Since Canada is primarily a host country for United States FDI, the major interest of the United States has been in negotiating downward the withholding taxes that Canada levies on payments that Canadian affiliates make to their United States parents, including dividends, management and licence fees, and royalties. Lower withholding taxes, however, mean substantial revenue losses for the Government of Canada so that the country has traditionally resisted lowering these rates on non-resident income. In the 1980 treaty negotiations, the Government of the United States wanted a 10 per cent withholding tax on interest and five per cent on dividends; Canada wanted 15 per cent on both (Brean, 1994, p. 13). The outcome was 10 per cent on direct dividends and 15 per cent on interest and royalty payments.

Starting in 1990, the Canadian and United States Governments began negotiations on a new protocol. First signed in August 1994, revised and signed in March 1995, and in effect as of 1 January 1996, the protocol substantially enhances investment access for TNCs in at least five ways.

- First, the protocol substantially reduces withholding taxes on cross-border financial flows; taxes on direct dividends fall from 10 to 5 per cent, on interest payments from 15 to 10 per cent, and are eliminated on royalties. This reduces the costs of remitting funds from foreign affiliates to their parents, and between affiliates, and, given the relative size of two-way flows, primarily benefits United States TNCs and/or the United States Treasury.

- Second, the non-discrimination clause, which previously had applied only to the CIT in both countries, is extended to all United States and Canadian taxes. This means that neither Government can use tax policies to discriminate against firms located in its territory that are owned by residents of the other country. There is, however, no mention of a NAFTA investor clause such as exists in the United States-Mexico treaty (see below), nor are there any MFN articles which could further reduce Canada-United States withholding taxes.

- Third, the 1985 treaty allowed the exchange of information on income, estate and gift taxes between the two federal taxing authorities. The new protocol expands the exchange to cover all taxes imposed by two countries, and to allow the disclosure of information related to income or capital taxes to provincial and State tax authorities. Thus it is easier for the one government to obtain information about related party transactions in the other country.[14]

- Fourth, the protocol adds a new article dealing with mutual assistance in tax collection; each country undertakes, but is not obliged, to collect the other's ''finally determined'' taxes as if they were its own taxes. Again, this clause encourages cooperation between the tax authorities.

- Lastly, an arbitration procedure may be added to the mutual agreement article if the two parties agree; this decision is to be made three years after the protocol enters into force. A binding arbitration procedure is now in place within the European Union (see Pagan and Wilkie, 1993); under this procedure investors can request that a board be established to arbitrate in international transfer-pricing disputes. The article in the Canada-United States protocol merely commits the parties to discussing the possible addition of an arbitration option; however, it does suggest that the two Governments are considering new, additional dispute-settlement procedures which would strength the regulatory environment for TNCs.

The 1991 Canada-Mexico Tax Treaty

In 1990, Canada and Mexico signed an information-exchange agreement, which was followed in 1991 by a bilateral income tax treaty, effective as of 1 January 1992 (Tax Analysts, 1995). The treaty provides several examples of a move towards deep integration at the tax level:

- First, national treatment is provided by setting equal taxation on non-nationals and on nationals, and in terms of being no less generous to non-residents than to residents.

- Second, an interesting addition is the most-favoured-nation clause; two types of most-favoured-nation clauses are introduced. The first is

[14] For example, the United States Government asked the Canadian Government for information about tax payments made by Ford of Canada to its US parent, Ford Motor Company.

a general commitment to ensuring that the tax on a non-resident company be no more burdensome than that afforded to residents of a third country. For example, if the Canada-United States tax treaty offered United States-controlled permanent establishments in Canada a better tax rate than that which Mexican-controlled affiliates received under the Canada-Mexico tax treaty, this article would ensure Mexican affiliates received the same treatment. At the end of the treaty, an additional article was added providing Canada with partial most-favoured-nation treatment for any Mexican bilateral tax treaty with an OECD country (presumably both parties had the United States in mind) that offered lower Mexican withholding taxes on interest and royalties. These two clauses are a first attempt to trilateralize the bilateral tax treaty process by extending the benefits of one set of negotiations to the other NAFTA tax partner.

The 1992 United States-Mexico tax treaty and 1994 tax protocol

The United States and Mexico signed their first bilateral income tax treaty[15] in September 1992 which took effect in January 1994, followed quickly by two protocols.[16] As table 3 shows, the withholding tax rates are generally lower than those negotiated under the Canada-Mexico tax treaty.[17] As these rates are phased in, the most-favoured-nation clauses in the second treaty should provide additional treaty benefits to Canadian investors in Mexico.

The United States-Mexico treaty incorporates the same national treatment article as the Canada-Mexico treaty. In addition, it provides a (so far unique) form of national treatment for NAFTA investors. The definition of affiliates eligible for benefits under the United States-Mexican tax treaty is

[15] A bilateral treaty on taxation of shipping and air transport income was signed in 1964 and updated in 1989, and an information-exchange agreement was signed in 1989, updated in 1990, with a protocol in 1994 (Tax Analysts, 1995).

[16] See Gordon and Ley (1994), Matthews (1993), McLees (1992, 1994), McLees and Reyes (1992), McLees *et al.* (1995), Morrison (1993, 1994), and Perez de Acha (1993, 1994).

[17] One of the interesting components of the United States-Mexico tax treaty is the Mexican 4.9 per cent withholding tax on interest payments. Almost all interest payments flow north from Mexico to the United States; therefore any reduction in the withholding tax reduced Mexican tax revenues per dollar of interest outflows. United States banks, however, wanted a low withholding-tax rate so their income would fall in the general financial services basket rather than in the high withholding-tax basket for United States tax purposes. Five per cent was the rate at which the interest payments would have to move into the high withholding-tax basket; so a 4.9 per cent rate was the maximum Mexico was able to negotiate (Morrison, 1993).

any subsidiary that is wholly owned, directly or indirectly, by publicly traded companies in any of the three NAFTA countries, with a minimum 50 per cent ownership in either the United States or Mexico. Thus a 51/49 per cent United States-Canadian joint venture in Mexico is eligible for United States-Mexico tax treaty benefits (Morrison, 1992, pp. 829-831). While no general most-favoured-nation clause exists, there is a restricted clause whereby the United States agrees that if it should negotiate lower withholding taxes on direct dividends with a third country, both parties will adopt that lower rate.

Two interesting extensions appear in the 1994 protocol to the income tax treaty. In anticipation of NAFTA, United States-Mexico cross-border flows have significantly increased and are expected to do so in the future. Therefore tax authorities on both sides of the border have become more interested in data collection for tax purposes. In one protocol the two Governments agree to exchange information on all taxes, not just those listed in the Convention (which is the standard article, see the Canada-Mexico treaty for an example). Second, as in the Canada-United States protocol, the two Governments have agreed to discuss in three years' time the establishment of a binding arbitration procedure for resolving bilateral tax disputes. The 1994 protocol also details how such a procedure would work.[18]

Summing up the treaties

Table 3 clearly shows the move to adopt the national treatment norm for taxation under the three bilateral tax treaties. While each treaty has unique components, and only the Mexico-related treaties have most-favoured-nation clauses, the potential exists to harmonize these three treaties by adopting common standards.

Taxation in NAFTA

Article 2103, "Taxation", of NAFTA is one of several types of exceptions to the commitments under the NAFTA table 1.[19] The article states that

[18] Arbitration can be an effective dispute resolution technique, particularly in cases where the tax amounts in dispute are very large and one of the governments is unwilling to provide offsetting relief, so the introduction of an arbitration procedure is to be welcomed. A similar clause has just been ratified by the 12 members of the European Union; the European Union arbitration option began a trial three-year period in 1995.

[19] The others are general exceptions, national security, balance of payments, disclosure of information and cultural industries (table 1).

nothing in NAFTA applies to taxation measures, or affects the rights or obligations of any NAFTA party as outlined in its bilateral tax treaties if an inconsistency between NAFTA and a bilateral tax convention should occur, the tax convention shall prevail to the extent of the inconsistency. In sum: *taxes are not in NAFTA, and where there is a conflict, tax conventions take precedence.*

However, this is not the end of the story. There are four general exceptions to the exception; that is, the Act specifies four places—four tax obligations—where NAFTA *does* apply to tax measures.

The first tax obligation is in two parts. Subsection (*a*) states that article 301 (national treatment for cross-border trade in goods) applies to taxation measures to the same extent as does article III of GATT (national treatment). Subsection (*b*) states that articles 314 (export taxes on goods) and 604 (export taxes on energy) apply to taxation measures; that is, the use of a tax on exports to one NAFTA member country is prohibited unless the tax is levied on exports to all other NAFTA members and on domestic consumption.

Subsection (*b*) is straightforward; if export taxes are to be levied, they must apply to all parties and to domestic sales so that no party receives treatment any less favourable than that available to nationals. Subsection (*a*) is more complicated. Under GATT, national treatment requires the treatment of imported goods, once they are inside the country, to be no worse than that of domestically produced goods.[20] In practice, this has meant answering the question: what should two governments do about border tax adjustments?

The common approach (see Jackson, 1989, pp. 194-197) to this problem is to apply the destination principle and provide national treatment in terms of where the goods are finally sold (i.e. the importing country). That is, an importing government can charge a tax on imports equivalent to any similar internal tax it imposes on domestic goods (e.g. if a value added tax (VAT) is levied on domestic goods, a VAT can be levied on imports) since that is the final destination for the imports. At the same time the government can rebate the amount of any internal tax on goods that are exported (i.e. exports are VAT exempt) on the grounds that a foreign country is the final destination for exports. The implication of (*a*) therefore is to allow border

[20] This rule is designed to discourage governments from using domestic taxes as protectionist measures.

tax adjustments, similar to those permissible under GATT for tariffs and export taxes.

The second tax obligation also has two parts. Subsection (*a*) states that national treatment for cross-border trade in all services (including financial services) applies to taxes on income, capital gains or taxable capital of corporations, and to the Mexican business assets tax, in so far as these taxes relate to the *purchase or consumption of particular services.* Traditionally, indirect taxes (sales, excise, value added taxes) have been considered as eligible for border tax adjustment, while direct taxes (personal and corporate income taxes) have not. The taxes listed in (*a*) are direct taxes and as such, would not be eligible for border tax adjustment. This rule says that, where these taxes relate to the purchase or consumption of particular services—i.e. where they, in effect, become indirect taxes—they can follow the national treatment rules. The United States subsection (*a*) is similar in its commitments to the rules on border taxes in GATT (UNCTAD, 1994, pp. 82-85).

Subsection (*b*) of the second tax obligation states that national treatment and most-favoured-nation norms, as they apply in NAFTA to investment and cross-border trade in all services, also apply to *all* taxation measures related to investment and services, but *excluding* taxes on income, capital gains, or taxable income of corporations, taxes on estates, inheritances, gifts and generation-skipping transfers, and the Mexican business assets tax (i.e. excluding direct taxes). No new non-conforming measures can be adopted, but all old ones are grandfathered (as was done in the investment chapter in CAFTA).

The third tax obligation states that NAFTA rules outlawing performance requirements shall apply to taxation. The following types of performance requirements are illegal under NAFTA: domestic content rules, preferences to local products, trade balances or exchange rate inflows, or ratios of sales to exports or foreign exchange earnings. The United States taxes (or tax incentives) could not be used in this manner. However, taxes or tax incentives related to performance requirements that are permissible in chapter 11 (e.g. locate production, provide a service, train or employ workers, construct or expand facilities, or carry out R & D) are also permissible here.

The last tax obligation has to do with expropriation. An investor, where taxation has been used to expropriate an investment, can invoke a claim for compensation. However, the taxpayer must first get a ruling from the Competent Authorities that expropriation did occur. If there is no ruling, or it goes against the investor, the investor can still submit a claim for arbitration under the investment chapter, using either the ICSID Convention or the UNCITRAL Arbitration Rules.

Summary: tax harmonization in North America

Taxation in North America is a mixture of national (domestic tax rules), bilateral (BTTs), trilateral (sect. 2103 in NAFTA) and multilateral regulations (the tax rules in GATT, the OECD Model Tax Treaty). Unlike interregional trade, where there has been significant movement in trilateralizing policies in order to achieve deep integration, in the taxation area, unilateral and bilateral rule-making dominates. Tax treaties allow governments to coordinate their tax systems, mutually negotiate lower withholding tax rates on outflows of non-resident income, and use the Competent Authority process to handle cross-border tax disputes.

In NAFTA, non-conforming tax measures have simply been grandfathered; there is no commitment to reduce these tax barriers. Thus, while national treatment is an underlying norm, the basic policy approach to taxation in North America has been one of coordination and dispute settlement rather than the movement towards harmonization and integration that is characteristic of NAFTA. The geographic scope of taxation is also less than for trade or investment policies since it is bilateral rather than trilateral. One can conclude that trade and investment policies within North America are stronger/harder forms of economic integration than tax policy.

There is some evidence that this is changing. The most-favoured-nation commitments in the Canada-Mexico tax treaty are one example. Another is the commitment to discuss setting up a binding arbitration process for tax disputes. However, tax policy would have to go some distance to achieve the commitments to deep integration that are embodied in the trade and investment provisions in NAFTA.

The emerging North American investment regime

This article has tried to document the movement within North America to develop a common regional regulatory approach to TNCs. This approach is designed to reduce the tariff and non-tariff barriers restricting the movement of goods, services, capital and intellectual property within the region, thus encouraging TNCs to pursue more integrated production and marketing strategies. A North American investment regime is emerging, based on the norm of national treatment, and extended through harmonization and coordination of national policies, such as corporate income taxes that affect TNCs.

Building on figure 1, one can picture the emerging regime in three dimensions: (1) geographic scope (number of countries), (2) strength of international regulation (from weak/soft to strong/hard regulation), and (3) depth of integration (from shallow to deep integration). (Fig. 2).

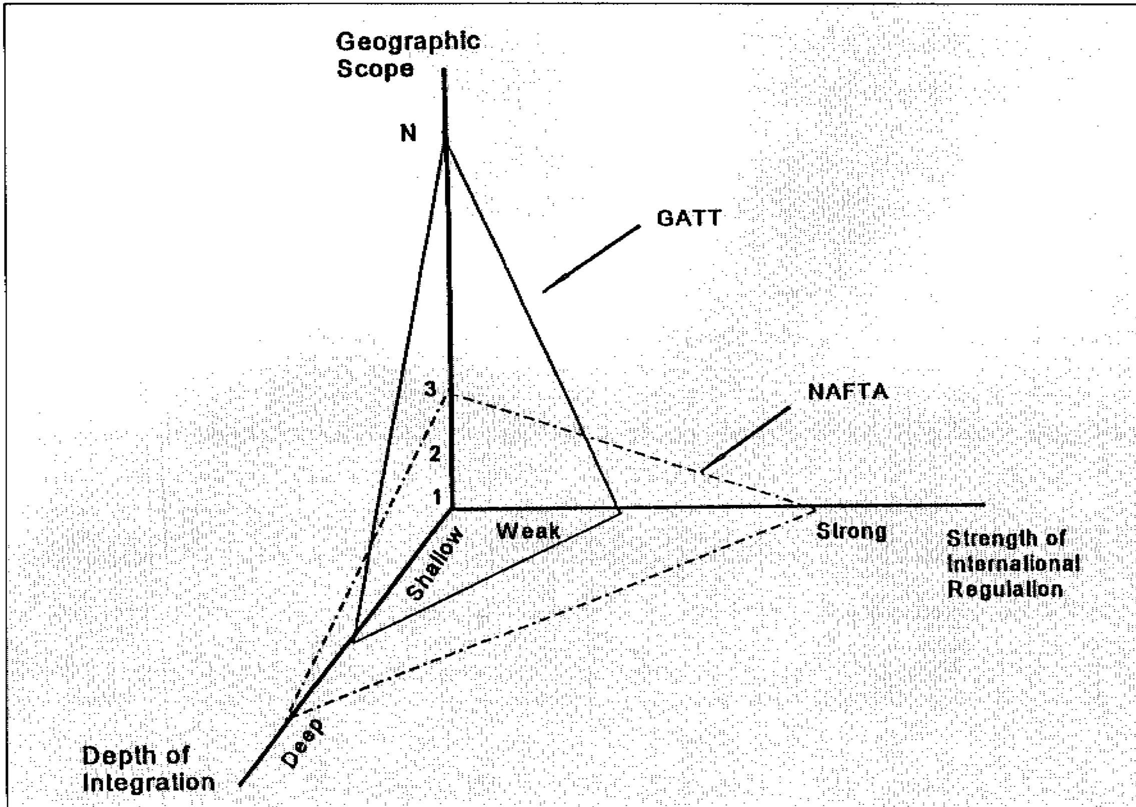
Comparing GATT to NAFTA, it is clear that GATT covers a much larger geographic area, but has significantly weaker powers of international regulation. In addition, the depth of integration is far less since GATT covers primarily trade in goods and is only slowly being extended to services and intellectual property. NAFTA, on the other hand, while much smaller, is a stronger and deeper form of integration. The implication is that small groups of like-minded States may be able to accomplish a deeper, stronger international investment regime than can be accomplished at the multilateral level.

Figure 2, however, compares GATT with NAFTA, rather than WTO with NAFTA. Under WTO, the strength of international regulation is significantly increased because the dispute-settlement mechanism is now stronger. A WTO panel can determine whether a particular member country has breached GATT rules; parties to a dispute can agree to binding arbitration; and a damaged party now has the right to apply sanctions commensurate with the damage. There are still some differences because the WTO mechanism does not deal directly with investment disputes (this is a depth of integration issue, however, not a strength issue) and only governments have standing in the dispute settlement (which is a strength issue). Thus, the WTO plane should be further to the right than the GATT plane in figure 2 (see Graham, 1994, pp. 15-18).

Some problems . . . and possible policy solutions

Sylvia Ostry has argued that the domestic domain is the new international policy arena because ''a globalizing world has a low tolerance for systems divergence'' (Ostry, 1992, p. 7). In a post-Uruguay Round world, she suggests that the multilateral trading system must be extended to include domestic rules that affect firm competitiveness and access to foreign mar-

Figure 2. Comparing International Regimes



kets. In the FDI area, she argues that the major source of system friction among the OECD countries is the asymmetry of market access; governments need to promote the harmonization of domestic policies in order to provide reciprocity of market access for FDI. While Ostry was clearly thinking of the imbalances in inward FDI stock between the United States and Japan, this article suggests there are system frictions within the emerging North American investment regime. One can identify several areas, but here only three are discussed.

The first deals with tax harmonization. Compared to the current state of tax harmonization under bilateral tax treaties and article 2103, the commitments made by the three Governments in trade and investment policies under NAFTA are stronger (i.e. more binding), deeper (in that they cover more areas) and have the advantage of being trilateral. Thus, the third ''face'' of the North American investment regime—tax policy—is the weakest part of the regime, and thus the area where the most regional policy coordination is required.

Within North America, there are three bilateral tax treaties, each with different withholding-tax rates and standards of treatment. This offers the potential for trilateral, rather than bilateral, interregional coordination, possibly along the lines of a free trade agreement applied to taxation. For example, the three Governments could negotiate the reduction or removal of internal withholding taxes, plus establish rules of origin to prevent treaty shopping by non-NAFTA parties.[21] This, however, leaves the differences in general corporate income tax rates and tax bases untouched, so there is much more to be done in this area of basic harmonization.

In addition, the three countries could establish a trilateral dispute-settlement mechanism, similar to that provided in chapter 11 (investment) in NAFTA. Another suggestion would be to establish a trilateral arbitration board to hear cross-border tax disputes. And, lastly, similar to NAFTA, a working group of tax officials from the three countries could meet regularly to discuss unilateral tax policy changes and areas where harmonization could usefully be undertaken. In sum, a North American Investment Regime

[21] One problem with this is that the bulk of intra-firm financial transfers within North America moves from Canadian and Mexican affiliates to their United States parent firms. Canadian and Mexican revenue authorities would be primary losers from such a move; tax revenues would have to be generated in some other fashion to offset these losses. Thus harmonization, rather than elimination, of intraregional withholding rates is more likely.

requires a trilateral treaty for taxation, similar to that provided for trade and investment by NAFTA.

The second problem is holes in the commitment to national treatment. NAFTA has "carve-outs" in its exceptions chapter and the annexes, that weaken the degree of regional economic integration. Most of the derogations are in the investments and services chapters, and thus preclude effective market access for investors and investments within NAFTA. Since the annexes are in the form of lists (clearly preferable to grandfathering!), they offer the potential for further negotiations to reduce the list of derogations from the national treatment principle.

The exceptions chapter (e.g. including the taxation article) also offers the opportunity for further negotiations to broaden and deepen the North American Investment Regime. For example, the grandfather clause in article 2103, removing non-conforming tax measures from the commitment to national treatment, should be removed and replaced with a list of exemptions (similar to the list of exceptions to investment and services in the annexes).

The third potential problem is the possible accession of Chile to NAFTA. Mexico and Chile have a free trade agreement, and Canada and Chile are currently negotiating one. After the presidential election in the United States, it is quite likely that these two bilaterals will result in Chile becoming the fourth NAFTA member country. While most commentators have focused on Chile's open regime in trade and investment, there has been no discussion of the fact that Chile does not have a bilateral tax treaty with any of the NAFTA partners.[22] Just as Mexico moved to adopt bilateral tax treaties with Canada and the United States, so too would Chile have to initiate this process. This is also true of most of the Latin American countries, should governments proceed from NAFTA to a Free Trade Area of the Americas (proposed for 2005). The Chile example suggests that the addition of more countries to NAFTA is likely to slow down or dilute the move to a North American investment regime, just as the addition of Mexico to NAFTA may have slowed the process of integration between Canada and the United States.

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[22] Chile only has a 1992 agreement on the taxation of shipping and air transport income with Canada (no exchange of information or tax treaty). There are no bilateral tax accords between Chile and Mexico. Chile and the United States have a 1975 agreement (updated by an exchange of notes in 1986 and 1990) on the taxation of air transport income, but that is all (Tax Analysts, 1995).

Conclusions

The trade and investment rules facing TNCs in North America have moved well beyond simple, shallow integration into a deeper, more complex integration based on the norm of national treatment. Policies that used to be determined unilaterally are now made in, or moderated by, formal bilateral or trilateral institutions. NAFTA, with its binding commitments in trade and investment policies, has changed the policy framework facing TNCs in North America from soft/weak international cooperation to a formalized, stronger regulatory environment. At the same time, bilateral tax treaties are harmonizing tax rules in North America.

This article has attempted to show how these changes in trade, investment and tax policies are creating a North American investment regime. While problems remain, the three countries have significantly levelled the playing-field for TNCs and improved their effective cross-border trade and investment access. The emerging investment regime, if effective, will restrain the three Governments from unilaterally changing their trade, tax and investment regulations. In this article, a number of suggestions have been made on the possible rules that should govern FDI in North America in the future. The proof will be in the eating. ■

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Appendix 1

Trade, Investment and Tax Policies: Regulating Transnational Corporations in North America

North American Trade Policies Affecting TNCs

Tariffs (Unilateral, NAFTA, GATT)

* Rates and bases (within and external to the region)
* Rules of origin
* Duty drawbacks/remissions
* Customs valuation code

Non-tariff barriers (Unilateral, NAFTA, GATT)

* Subsidies—firm, industry, region
* Quotas, export taxes and voluntary export restraints
* Preferential procurement practices
* Regulatory barriers
* Transport barriers

Trade remedy legislation (Unilateral, NAFTA, GATT)

* Antidumping and countervailing duties
* NAFTA general dispute-settlement procedures
* Emergency actions
* Section 301

North American Investment Policies Affecting TNCs

FDI regulations (Unilateral, BITs, CAFTA, NAFTA)

* Investment Canada
* Committee on Foreign Investment in the US (CFIUS)
* Mexico's Investment Decree
* Industry regulations: key sector (banking, energy, finance, automobiles)
* Expropriation
* Investment dispute-settlement procedures

Trade in services (Unilateral, NAFTA)

* Business services
* Financial services
* Movement of business persons

Trade in intellectual property (Unilateral, NAFTA, WIPO)

* Patents, copyrights, trademarks

Competition policy (Unilateral)

North American Tax Policies Affecting TNCs

Federal corporate income tax (Unilateral, BTTs, OECD Model Tax Convention)

* Rates and bases, integration with personal income tax
* Treatment of foreign source income
* Treatment of income of foreign TNCs
* Treatment of tax avoidance and evasion
* Dispute-settlement procedures
* Reduced tax rates for export income (United States Foreign Sales Corp.)

* Bilateral tax treaties, exchange of information
* Arm's length standard for pricing intra-firm transactions

State corporate income and business taxes (Unilateral, NAFTA)

* Rates and bases
* Location incentives (tax holidays), Free Enterprise Zones
* Two-year window to list exemptions under NAFTA

Withholding taxes (Unilateral, Bilateral Tax Treaties)

* Rates and bases

Other taxes (Unilateral, Bilateral, NAFTA)

* Personal income taxes, capital gains, wealth taxes
* Sales, excise and value added taxes
* Border tax adjustments

Bilateral tax treaties (Bilateral, OECD Model Tax Convention)

* Definition of taxable income, nexus, source and residence principles
* Reduction of withholding-tax rates
* Exchange of information
* National treatment, MFN
* Dispute settlement through competent authority process