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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

INCENTIVES

**UNCTAD Series
on Issues in International Investment Agreements**



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NOTE

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The following symbols have been used in the tables:

Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row;

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IIA Issues Paper Series

The main purpose of the UNCTAD Series on issues in international investment agreements – and other relevant instruments – is to address concepts and issues relevant to international investment agreements and to present them in a manner that is easily accessible to end-users. The series covers the following topics:

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Preface

The secretariat of the United Nations Conference on Trade and Development (UNCTAD) is implementing a work programme on international investment agreements. It seeks to help developing countries to participate as effectively as possible in international investment rule-making at the bilateral, regional, plurilateral and multilateral levels. The programme embraces policy research and development, including the preparation of a Series of issues papers; human resources capacity-building and institution-building, including national seminars, regional symposia, and training courses; and support to intergovernmental consensus-building, as well as dialogues between negotiators and groups of civil society.

This paper is part of this Series. It is addressed to Government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers. The Series seeks to provide balanced analyses of issues that may arise in discussions about international investment agreements. Each study may be read by itself, independently of the others. Since, however, the issues treated closely interact with one another, the studies pay particular attention to such interactions.

The Series is produced by a team led by Karl P. Sauvant and James Zhan. The principal officer responsible for its production is Anna Joubin-Bret who oversees the development of the papers at various stages. The members of the team include Federico Ortino and Jörg Weber. The Series' principal advisors are Peter Muchlinski, Patrick Robinson and Pedro Roffe. The present paper is based on a manuscript prepared by Joachim Karl and Marcela Anzola. The final version reflects comments received *inter alia* from Anders Ahnliid, Ivo Kaufmann, Mark Koulen and M. Sornarajah. The paper was desktop published by Teresita Sabico.



Rubens Ricupero
Secretary-General of UNCTAD

Geneva, December 2003

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UNCTAD has carried out a number of activities related to the work programme in cooperation with other intergovernmental organizations, including the Agence pour la Francophonie, Banco Centroamericano de Integración Económica, CARICOM Secretariat, German Foundation for Development, Inter-Arab Investment Guarantee Corporation, Inter-American Development Bank (BTD/INTAL), League of Arab States, Organization of American States, Secretaria de Integración Económica Centroamericana and the Secretaria General de la Comunidad Andina. UNCTAD has also cooperated with non-governmental organizations, including the Centre for Research on Multinational Corporations, the Consumer Unity and Trust Society (India), the Dutch Foundation for Research on Multinationals (SOMO) (The Netherlands), the Economic Research Forum (Egypt), the European Roundtable of Industrialists, the Friedrich Ebert Foundation (Germany), the German Foundation for International Development, the International Confederation of Free Trade Unions, the Labour Resource and Research Institute (LaRRI) (Namibia), Oxfam, the Third World Network and World Wildlife Fund International. Since 2002, a part of the work programme has been carried out jointly with the World Trade Organization (WTO).

Funds for the work programme have so far been received from Australia, Brazil, Canada, France, Japan, The Netherlands, Norway, Sweden, Switzerland, the United Kingdom and the European Commission. Argentina, Botswana, China, Colombia, Costa Rica, Croatia, Cuba, Czech Republic, Djibouti, Egypt, Gabon, Germany, Guatemala, India, Indonesia, Jamaica, Malaysia, Mauritania, Mexico, Morocco, Namibia, Pakistan, Peru, Qatar, Singapore, South Africa, Sri Lanka, Thailand, Trinidad and Tobago, Tunisia, Venezuela and Yemen

have also contributed to the work programme by hosting regional symposia, national seminars or training events.

In pursuing this programme of work, UNCTAD has also closely collaborated with a number of international, regional and national organizations, particularly with the Centro de Estudios Interdisciplinarios de Derecho Industrial y Económico (the Universidad de Buenos Aires), the Indian Institute of Foreign Trade, the Legon Centre of Accra (Ghana), ProInversión (Peru), Pontificia Universidad Católica del Perú, the National University of Singapore, Senghor University (Egypt), the University of Dar Es Salaam (Tanzania), the University de Los Andes (Colombia), the University of Campinas (Brazil), the University of Lima (Peru), the Universidad del Pacífico (Peru), the University of Pretoria (South Africa), the University of Tunis (Tunisia), the University of Yaoundé (Cameroon), the Shanghai WTO Affairs Consultation Center (China) and the University of the West Indies (Jamaica and Trinidad and Tobago). All of these contributions are gratefully acknowledged.

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Executive summary

Incentives are frequently used as a policy instrument to attract foreign direct investment (FDI) and to benefit more from it. They can be classified as financial, fiscal or other (including regulatory) incentives.

The issue of incentives is a relatively new phenomenon in international investment agreements (IIAs). Up to now, the great majority of IIAs have not contained specific provisions related to them. Rather, the “normal” treaty rules on investment protection apply, such as the principle of non-discrimination, and provisions on taxation and State contracts. This approach leaves considerable discretion to host countries in the design and application of their national incentive programmes. They remain free to reserve incentives to certain categories of companies or to certain investment locations, provided that they respect the principle of non-discrimination. The only multilateral agreement to control certain incentives is the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures (SCM Agreement). It covers trade-related subsidies. It may also cover trade-distorting investment subsidies including investment incentives.

Given the important role that incentives are seen to play in the global competition to attract FDI and benefit more from it, the tendency in more recent IIAs – in particular at the regional and multilateral level – has been to deal with them explicitly. Issues that most frequently arise in this context are the definition of “incentives”, the application of the non-discrimination principle to regulate incentives (including the conditioning of incentives to performance requirements), transparency in relation to incentives policies, addressing incentives competition by limiting the lowering of regulatory standards or by establishing international control and consultation mechanisms with regard to the

granting of incentives, and the encouragement of development-oriented incentives both on the part of host and home countries.

Incentives can be a tool for countries to pursue their development strategies. If used properly, they can compensate for some deficiencies in the business environment that cannot easily be remedied. They can also help correct the failure of markets to capture wider benefits from externalities of production. At the same time, incentives may result in competition between countries and divert financial resources that could otherwise be more effectively used for development purposes. Moreover, the effectiveness of incentives is uncertain in a number of circumstances. Experience suggests that incentives do not rank high among the determinants of FDI and that in many instances incentives can be a waste of resources.

The main options for dealing with incentives in IIAs lie between not having any specific rules on incentives in IIAs and including provisions on incentives. In the latter case, certain further options present themselves, including a definition of “incentives”; relying on the principle of non-discrimination to regulate incentives policies, including the conditioning of incentives to performance requirements; ensuring transparency in relation to incentives policies; addressing incentives competition by limiting the lowering of standards; establishing international control or consultation mechanisms for the granting of incentives; and encouraging development-oriented incentives both on the part of host and home countries.

INTRODUCTION

One of the features of globalization is the worldwide competition for FDI. Over the past two decades, most countries have liberalized their investment regimes and opened most sectors of their economies to foreign investors. During 1991-2002, 95% of 1,641 FDI policy changes created a more welcoming environment for FDI (UNCTAD, 2003a, p. xvii). In 2002 alone, 248 changes in FDI laws were made, of which 236 (96%) created a more favourable investment climate (UNCTAD, 2003a, p. 21). Incentives are one of the policy tools used for this purpose. Furthermore, they are used to increase benefits from FDI for host countries. They can involve financial aid, fiscal benefits or other incentives (including the relaxation of regulatory standards that foreign investors would otherwise have to respect).

Surveys indicate that the number of countries granting investment incentives and the range of possible incentive measures is on the rise (UNCTAD, 1996a, pp. 3-4; UNCTAD, 2003a, p. 124). This reflects the growing number of countries that proactively pursue investment promotion efforts. The result is a highly competitive world market for FDI which, in light of the recent downturn in global FDI flows (UNCTAD, 2003a), is likely to become even more competitive. Against this background, the purpose of this paper is to describe and analyse how incentives are dealt with in the context of IIAs.

Section I defines “investment incentives” and outlines the key issues in the current policy debate on this topic: the definition of “incentives”, the application of the non-discrimination principle to regulate incentives (including the conditioning of incentives to performance requirements), transparency in relation to incentives policies, addressing incentives competition by limiting the lowering of regulatory standards or by establishing international control or consultation mechanisms with regard to the granting of incentives and the encouragement of development-oriented incentives both on the part

of host and home countries. This section further examines the function of incentives from different angles, including the perspective of foreign investors and host countries. From the point of view of foreign investors, it is important to know under which conditions they are entitled to incentives, and whether they are protected against discrimination. Host countries need to assess whether and under what circumstances incentives may promote their development objectives, and whether they do in fact make a difference to the achievement of those objectives.

Section II gives an overview of how IIAs deal with the key issues pertaining to incentives. Section III then analyses the interaction of incentives with other issues and concepts included in IIAs. Section IV examines the economic and development implications of incentives and puts forward options of how this issue could be dealt with in IIAs.

Section I

EXPLANATION OF THE ISSUE

A. What are investment incentives?

There is no uniform definition of what constitutes an “investment incentive”. (Box I.1. contains a list of commonly used incentives.) The only major international instrument that contains a partial definition is the SCM Agreement (see below). Governments use three main categories of investment incentives to attract FDI and to benefit more from it:

- financial incentives, such as outright grants and loans at concessionary rates;
- fiscal incentives such as tax holidays and reduced tax rates;
- other incentives, including subsidized infrastructure or services, market preferences and regulatory concessions, including exemptions from labour or environmental standards.

Incentives can be used for attracting new FDI to a particular host country (locational incentives)¹ or for making foreign affiliates in a country undertake functions regarded as desirable such as training, local sourcing, research and development or exporting (behavioural incentives). Most incentives do not discriminate between domestic and foreign investors, but they sometimes target one of the two. In some countries, such as Ireland, the entire incentive scheme was geared to FDI for a long period.² Incentives may also favour small firms over large, or vice versa. They are offered by national, regional and local governments (UNCTAD, 2003a, p. 123).

Among the broad range of possible incentives, financial and fiscal incentives are the ones most frequently employed. Developing countries often prefer fiscal instruments, such as tax holidays, concessionary tax rates, accelerated depreciation allowances, duty drawbacks and exemptions, whereas developed countries mainly use financial incentives, including cash grants (exceeding sometimes 50% of the investment costs) and interest-free or subsidized loans. This may be seen as reflecting differences in wealth, as developed countries can afford to use up-front subsidies for inward investment whereas developing countries can, at best, afford to ease the tax burden *ex post*.

Box I.1. Types of incentives

Financial incentives

- Investment grants: “direct subsidies” to cover (part of) capital, production or marketing costs in relation to an investment project.
- Subsidized credits and credit guarantees: subsidized loans/ loan guarantees/ guaranteed export credits.
- Government insurance at preferential rates/ publicly funded venture capital participating in investments involving high commercial risks. Government insurance at preferential rates, usually available to cover certain types of risks such as exchange-rate volatility, currency devaluation, or non-commercial risks such as expropriation and political turmoil (often provided through an international agency).

Fiscal incentives

- Profit-based: reduction of the standard corporate income tax rate/ profit tax rate/ tax holiday.
- Capital-investment-based: accelerated depreciation/ investment and reinvestment allowance.
- Labour-based: reduction in social security contribution/ deductions from taxable earnings based on the number of employees or on other labour related expenditure.
- Sales-based: corporate income tax reductions based on total sales.
- Import-based: duty exemptions on capital goods, equipment or raw materials, parts and inputs related to the production process; tax credits for duties paid on imported materials or supplies.
- Export-based: export tax exemptions; duty drawback; preferential tax treatment of income from exports, income-tax reduction for special foreign-exchange-earning activities or for manufactured exports; tax credits on domestic sales in return for export performance; income-tax credits on net local content of exports; deduction of overseas expenditures and capital allowance for export industries.
- Based on other particular expenses: corporate income tax deduction based on, for example, expenditures relating to marketing and promotional activities.

/...

Box I.1 (concluded)

- Value-added-based: corporate income tax reductions or credits based on the net local content of outputs; granting income-tax credits based on net value earned.
- Reduction of taxes for expatriates.

Other incentives*Regulatory incentives*

- Lowering of environmental, health, safety or labour standards.
- Temporary or permanent exemption from compliance with applicable standards.
- Stabilization clauses guaranteeing that existing regulations will not be amended to the detriment of investors.

Subsidized services

- Subsidized dedicated infrastructure: electricity, water, telecommunication, transportation/ designated infrastructure at less than commercial price.
- Subsidized services, including assistance in identifying sources of finance, implementing and managing projects, carrying out pre-investment studies, information on markets, availability of raw materials and supply of infrastructure, advice on production processes and marketing techniques, assistance with training and retraining, technical facilities for developing know-how or improving quality control.

Market privileges

- Preferential government contracts.
- Closing the market to further entry or the granting of monopoly rights; protection from import competition.

Foreign exchange privileges

- Special treatment with respect to foreign exchange, including special exchange rates, special foreign debt-to-equity conversion rates, elimination of exchange risks on foreign loans, concessions of foreign exchange credits for export earnings, and special concessions on the repatriation of earnings and capital.

Source: UNCTAD, based on UNCTAD, 1996a, 1996b and WTO, 1998.

B. What key policy issues are at stake?

As noted above, incentives are a policy tool in the global competition to attract FDI and benefit more from it. This raises a number of key policy issues, in particular:

- The definition of “incentives”. The definition of incentives acquires special urgency in the context of IIAs where the applicability of their provisions on incentives will be determined, in the first instance, by the definition of what constitutes an incentive. Given the relative lack of precedents in this area, arising from the fact that only a few IIAs deal expressly with incentives, some guidance may be offered by the SCM Agreement.
- The application of the non-discrimination principle to regulate incentives (including the conditioning of incentives to performance requirements). The principle of non-discrimination, in the form of the national treatment and the most-favoured-nation (MFN) treatment, may be employed, in the context of IIAs, to prohibit host countries from differentiating in their incentives programmes on the basis of the nationality of an investor or an investment. But its applicability does not preclude the selection of investors/investments eligible for incentives on the basis of other objective criteria, such as the business sector or the size or location of a company. In addition, the applicability of the non-discrimination principle to incentives may be subject to several important limitations, for example, with regard to incentives granted at the pre-establishment phase of an investment, subsidies provided by a government entity, fiscal incentives or subsidies granted for research and development purposes. But investment incentives conditioned on the fulfilment of certain performance requirements by a foreign investor as an industrial development instrument may, under certain conditions, be caught by the principle of non-discrimination. The aim behind such requirements is to ensure the fullest economic utility of an investment to a host

country and, in particular, its development objectives. On the other hand, such measures could be regarded as having negative effects on economic efficiency, by imposing unwanted additional burdens upon investors (UNCTAD, 2003a, pp. 119-120).

- Transparency in relation to incentives policies. Transparency relates to the openness and impartiality of the decision-making process in the design, introduction and administration of incentives. It provides firms with more predictable conditions for access to, and operation in, foreign markets; it also helps to reveal covert discrimination and reduces the risk of arbitrary administrative or political decisions (OECD, 2000). A lack of transparency may be the single greatest cost of incentive programmes, because it creates significant possibilities for corruption and other types of rent-seeking behaviour. This in turn can be detrimental to the development of competitive markets and indeed to development itself (Oman, 2000, pp. 5, 73, 101).
- Addressing incentives competition by limiting the lowering of regulatory standards or by establishing international control or consultation mechanisms with regard to the granting of incentives. First, by lowering their domestic standards in areas such as health, environment or labour (through, for example, temporary exemptions from applicable rules or the stabilization of the existing legal regime to the effect that foreign investors are not adversely affected by future legislative changes),³ host countries may seek to reduce the investment costs for foreign investors, thereby increasing their attractiveness as a potential production site. In addition, some countries seek to control the availability of incentives and the terms upon which they are made available to investors, so as to minimize the risk of “incentives races” whereby countries compete for internationally mobile FDI projects by way of incentives that seek to better those on offer from other potential host countries that are seeking to attract the same investment.

- The encouragement of development-oriented incentives on the part of host and home countries. Certain development-oriented incentive policies have been used in regional integration agreements, mainly between developing countries in order to encourage the evolution of regional enterprises in developing regions by encouraging or even requiring the use of incentives by host countries. As such, these regimes raise issues of preferential access to markets and the preservation of an element of special and differential treatment for investors from other developing countries within the region. In addition, home countries may be able to encourage investment in developing countries through incentives offered to their investors to undertake such investments (e.g. technical assistance, technology transfer requirements, financial and fiscal incentives and investment insurance).

Notes

- ¹ A variation of locational incentives are site incentives seeking to influence the choice of a site within an economy, for instance, inducing investors to locate in a backward area or away from a congested area. Similarly, incentives can be used to attract FDI into certain industries.
- ² The application of the corporate tax regime in Ireland has never explicitly distinguished between foreign and domestic companies. However, most analysts agree that it was more beneficial to transnational corporations (TNCs), because of their greater level of exports and profits (UNCTAD, 2003a, p. 141).
- ³ Employment and environment are analyzed in detail in other papers of the UNCTAD Series on *Issues in International Investment Agreements* (UNCTAD, 2000a, 2001a).

Section II

STOCKTAKING AND ANALYSIS

This section gives an overview of how IIAs deal with investment incentives, focussing in particular on the key issues identified in the preceding section. Only relatively few treaties – mostly at the regional or multilateral levels – deal explicitly with incentives. However, the lack of express provisions on incentives does not necessarily mean that incentives are not subject to disciplines. Indeed, even within the negotiation concerning the Multilateral Agreement on Investment (MAI) by the Organisation for Economic Co-operation and Development (OECD), several delegations believed that no provision expressly addressing investment incentives was necessary since other draft articles sufficiently covered the issue.¹ However, the number of IIAs addressing expressly some types of incentives is gradually increasing, indicating the growing importance that some countries place upon this matter.

A. The definition of “incentives”

The definition of an “incentive” can be very broad, covering virtually any assistance offered by a country to investors, or it can be narrower, covering only specific types of assistance to investors. However, not many IIAs contain definitions of this term or related terms. For example, neither the General Agreement on Trade in Services (GATS), which refers to “subsidies” in article XV, nor the North American Free Trade Agreement (NAFTA), which excludes “subsidies or grants” from the operation of the national treatment and MFN obligations in its investment provisions, contain definitions of these terms.² The SCM Agreement is the only multilateral agreement containing a definition of a “subsidy”. The purpose of this agreement is the establishment of an international control mechanism concerning the granting of trade-related subsidies (box II.1). Nevertheless, its definition of a “subsidy” is relevant in the present context, because the terms “subsidy” and “incentive” overlap. As will be shown below, a “subsidy” in the meaning of the SCM Agreement is likewise an “incentive”, if granted to an investor.

Box II.1. Evolution of the rules on subsidies in the GATT

Article XVI GATT constitutes the first international obligation on subsidies of a multilateral character. In 1979, the “Tokyo Round” negotiations began over a more detailed discipline of subsidies and countervailing duties, resulting in a Subsidies Code, which covered not only export subsidies, but also “other than export subsidies” (article 11).

The “Uruguay Round” text on subsidies, mandatory for all members and officially entitled “Agreement on Subsidies and Countervailing Measures”, is extensive and detailed. Part I defines subsidies. Parts II, III and IV divide all specific subsidies into one of three categories: prohibited (red basket), actionable (yellow basket), and non-actionable (green basket) and establish certain rules and procedures with respect to each category, including specific dispute-settlement rules and procedures for each category. Part V establishes the substantive and procedural requirements that must be fulfilled for the application by a member of a countervailing measure against subsidized imports. Part VIII includes exemptions and transition periods for developing countries.^a

Source: WTO, 1999.

^a For further discussion see UNCTAD, 2001b, 2002b.

The SCM Agreement applies only to subsidies that affect trade in goods. According to article 1 of the SCM Agreement, a “subsidy” shall be deemed to exist if the following two conditions are fulfilled (WTO, 1999):

- there must be a “financial contribution by a government or any public body” or “any form of income or price support in the sense of Article XVI [Subsidies] of GATT [General Agreement on Tariffs and Trade] 1994;” and
- “a benefit is thereby conferred”.

Article 1 provides further details as regards the issue of what constitutes a “financial contribution by a government or any public body...”. The following measures are considered to fulfil this condition:

- a government practice involving a direct transfer of funds (e.g. grants, loans and equity infusion), or a potential direct transfer of funds or liabilities (e.g. loan guarantees);
- government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);
- a government provides goods or services other than general infrastructure, or purchases goods;
- a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated above (see the three previous bullets), which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.

A “subsidy” as defined in article 1 is subject to the substantive rules of the SCM Agreement if it is “specific”. Pursuant to article 2, this is the case if the subsidy is granted to an enterprise or industry or group of enterprises or industries. Article 2, in connection with Article 3, gives further guidance concerning the question whether a subsidy is “specific” or not:

- A subsidy is specific in the following four cases:
 - the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises;
 - it is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority;

- it is contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I to the Agreement;
 - it is contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.
- A subsidy is not specific:
 - where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions governing the eligibility for, and the amount of, a subsidy, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. The criteria or conditions must be clearly spelled out in a law, regulation, or other official document, so as to be capable of verification. Objective criteria or conditions, as used in this provision, mean criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of enterprise.
 - where the setting, or change, of generally applicable tax rates, by all levels of government entitled to do so, is concerned.
 - In case of doubts whether a subsidy is specific or not, the following factors may be considered: use of a subsidy programme by a limited number of certain enterprises, predominant use by certain enterprises, the granting of disproportionately large amounts of subsidy to certain enterprises, and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy. In regard of the latter, in particular, information on the frequency with which applications for a subsidy are refused or approved and the reasons for such decisions shall be considered. In applying these factors, account shall be taken of the extent of diversification of economic activities within the jurisdiction of the

granting authority, as well as of the length of time during which the subsidy programme has been in operation.

Thus, the SCM Agreement contains a broad definition that covers any kind of fiscal or financial incentive that relates to trade in goods and is found to be “specific” pursuant to the Agreement itself. It does not include regulatory incentives, like the lowering of environmental or social standards, since such incentives do not constitute a “financial contribution” by the government or other public bodies. Nor does it include general infrastructure advantages (regardless of whether it is provided at market prices). As a result, the SCM Agreement – while applying to fiscal and financial incentives – does not impose any obligations on governments concerning the granting of regulatory incentives or upon the provision of general assistance to businesses. Thus, for example, governments remain free to attract FDI through the use of export processing zones (EPZs), provided that they do not accord the grant of subsidies on condition that investors reach a given level of export performance, or that they use a certain level of domestic rather than imported inputs, or make subsidies specific to certain enterprises (Roessler and Valles, forthcoming).

During the ultimately unsuccessful negotiations on a draft MAI in the OECD, two suggestions had been made for a definition of an “investment incentive” to be applied specifically in relation to FDI. One proposal resembled strongly the definition in the SCM Agreement (see above). The alternative text in the draft reads as follows:

“[...] an ‘investment incentive’ means:

The grant of a specific advantage arising from public expenditure [a financial contribution] in connection with the establishment, acquisition, expansion, management, operation, or conduct of an investment of a Contracting Party or a non-Contracting Party in its territory.”

This definition is in some respects narrower than the definition in the SCM Agreement. First, it is limited to defining the term “investment incentive”, whereas the SCM Agreement defines a “subsidy” as such. Second, the draft MAI definition covers only those advantages that are “specific”. This term intends to distinguish incentives given across-the-board from those to which only certain investors or investments are entitled. It should be noted, however, that the SCM Agreement uses the same concept, although not in the context of the definition of a subsidy. In the SCM Agreement, “specificity” becomes relevant for the question of whether a subsidy is actionable or not.

In two respects, the scope of the definition in the draft MAI is broader than that of in the SCM Agreement. First, it would have covered incentives granted to investments of non-contracting parties. The reason for this approach was that otherwise the draft MAI disciplines on incentives would have had a major loophole – as compared to the WTO, the OECD has a much smaller membership. MAI contracting parties would have remained free to grant incentives to investors of non-contracting parties, thereby jeopardizing the objective to limit incentive-based competition for FDI comprehensively. Secondly, the draft MAI would have covered not only incentives relating to manufacturing and raw materials but also those applicable to services, whereas the SCM Agreement does not extend to the latter given its limitation to trade-related subsidies.

B. Non-discrimination

1. National and MFN treatment

The principle of non-discrimination, as applied in the context of IIAs, generally encapsulates the national and the MFN treatment obligations. They require that contracting parties treat foreign investors and investments in their territory at least as favourably as domestic

investors and investments (national treatment) or as investors and investments from any other third country (MFN treatment). In certain cases, such requirements are subject to a further condition that investors or investments be “in like circumstances”. Since incentives are granted in connection with investment-related activities, national and MFN treatment obligations can apply to them.

These two obligations may prohibit host countries from differentiating in their incentive programmes on the basis of the nationality of the investor. This means that – unless exceptionally permitted – they would not be allowed to reserve incentives for their domestic investors alone, or to target investors of only one particular foreign country. This does not preclude, however, the selection of investors eligible for incentives on the basis of other objective criteria, such as the business sector, the size or location of a company, or the amount of the invested capital. The principle of non-discrimination would therefore leave host countries considerable discretion to design their incentive programmes according to their individual investment policies and strategies.

In addition, there are some important limitations to the applicability of the non-discrimination principle to incentives. In this regard, two kinds of limitations have been used. On the one hand, there are limitations relating to specific sectors, resulting either from country-specific reservations (under a negative-list approach) or from the non-inclusion of a particular sector under a positive-list approach. On the other hand, a number of IIAs (such as NAFTA Chapter 11) exclude subsidies from the application of the national and MFN treatment obligations. Also, the applicability of national and MFN treatment to taxation measures is usually quite closely circumscribed.

a. The extent of protection

The great majority of bilateral investment treaties (BITs) only cover the “post-establishment phase”, i.e. they grant rights to foreign investors once they have established themselves in a host country. In other words, such BITs do not contain legally binding rules concerning the treatment of foreign investors wishing to make an investment. This means that incentives for making an investment (locational incentives) are not covered by the non-discrimination principle. Host countries would therefore be allowed, under these BITs, to reserve incentives for the establishment of an investment to their domestic investors. They would likewise have the right to favour investors of a particular foreign country over other foreign investors. However, caution would need to be exercised by a host country that is a member of the WTO to ensure that such favourable treatment is consistent with the requirements of the SCM Agreement in that the treatment would be generally available to all enterprises of a particular nationality and not to specific enterprises, and that it would not be conditional on the types of trade-related subsidies prohibited by the terms of the SCM Agreement (see further UNCTAD, 2002b, pp. 208-210).

Some regional or multilateral IIAs extend the application of the non-discrimination principle to the pre-establishment phase. This is the case, e.g. in the NAFTA. According to its articles 1102 and 1103, national and MFN treatment obligations apply, *inter alia*, to the establishment and acquisition of an investment. A more restricted approach is followed by the GATS: while it covers the establishment of a commercial presence (akin to the making of an investment), it establishes as a general rule only one part of the non-discrimination principle, namely, MFN treatment, although members do have the possibility of including temporary MFN exemptions in their schedules (article II), thus providing a legal basis to discriminate in the granting of incentives in sectors covered by an exemption. National treatment applies only if a member makes a voluntary commitment in this respect

(article XVII), and such commitments may be subject to country-specific limitations and conditions. To the extent that IIAs extend the principle of non-discrimination to the pre-establishment phase, it applies to locational incentives granted by a host country to foreign investors when making an investment. However, such IIAs may likewise contain an exception clause concerning the applicability of the non-discrimination clause to incentives that reverses this effect.

b. Exclusion of the non-discrimination principle from incentives

A few BITs exclude the applicability of the non-discrimination principle to incentives. For instance, according to article VI.2 of the 1996 BIT between Canada and Trinidad/ Tobago, the principle of non-discrimination does not apply to subsidies or grants provided by a government or a State enterprise, including government-supported loans, guarantees and insurance. Identical wording can be found in articles VI.2 of the Canadian BITs with Ecuador (1996), Panama (1996) and Barbados (1996).³ Similarly, the BITs concluded by the United States give the Government of that country the right to adopt or maintain exceptions in respect of subsidies and grants. However, such exceptions relate only to the principle of national treatment. The MFN treatment obligation remains applicable.

Pursuant to article 1108 (7) of the NAFTA, the principle of non-discrimination does not apply to procurement measures by a party or State enterprise, or to subsidies or grants provided by a party or a State enterprise, including government-supported loans, guarantees and insurance. More specifically, according to article 1108 (1) of the NAFTA, the principle of non-discrimination does not apply to any existing non-conforming measure that is maintained by a contracting party. This means that under NAFTA any non-conforming investment incentive has been “grand-fathered”, provided that it has been listed in a country-specific schedule annexed to the Agreement. In addition,

pursuant to article 1108 (3), contracting parties had the possibility to exclude the application of the non-discrimination principle in respect of measures concerning *sectors, sub-sectors or activities* that they have set out in their schedule to an annex to the Agreement. Accordingly, any NAFTA partner could exclude the applicability of the non-discrimination clause with regard to any *future* investment incentive granted for the sectors, sub-sectors, or activities specified in the schedule.

c. The treatment of fiscal incentives

Incentives are often granted in the form of fiscal measures (e.g. tax relief). IIAs usually exempt taxation matters from the scope of the agreement, as these are governed by separately negotiated bilateral taxation treaties between countries. The equilibrium of these agreements could be upset if the provisions of IIAs also extended to taxation. Two main approaches can be distinguished. The strongest exclusion can be found in the draft MAI. It excluded, in principle, taxation measures entirely from the scope of the Agreement. Only the provisions on expropriation and transparency remained applicable to such measures. By contrast, other IIAs modify the application of the principle of non-discrimination with regard to taxation measures:

- Some BITs exclude any taxation measure, irrespective of whether it is based on internal legislation or an international agreement, from the scope of application of the non-discrimination principle. This is, for instance, the case for the BITs concluded by the United Kingdom and France. BITs concluded by Malaysia include provisions excluding taxation measures from the application of the MFN treatment obligation.⁴
- Some countries exclude only those advantages from the non-discrimination principle that are included in an agreement relating wholly or partially to taxation. This is the case, for example, for the

BITs concluded by Chile and Germany. Another group of countries in this category (e.g. China, Switzerland) have adopted a narrower approach by referring only to advantages included in an agreement on the avoidance of double taxation.

- Pursuant to article 2103 (1) of the NAFTA, the Agreement does not, in principle, apply to taxation measures. However, according to article 2103 (4) the principle of non-discrimination remains applicable to taxation measures other than those – inter alia – on income, capital gains or on the taxable capital of corporations (i.e. mostly indirect taxes). In no case does the MFN treatment obligation apply with respect to an advantage accorded by a contracting party pursuant to a tax convention or to a non-conforming provision of any existing taxation measure.
- The Energy Charter Treaty (ECT) pursues a similar approach. Article 21 excludes, in principle, taxation measures of contracting parties from the scope of the agreement. However, according to article 21 (3), the principle of non-discrimination remains applicable to taxes other than those on income and on capital. Even with regard to those taxes, the MFN treatment obligation does not apply concerning advantages accorded by a contracting party pursuant to international taxation agreements or resulting from membership of a regional economic integration organization. Likewise, the principle of non-discrimination does not apply with regard to taxation measures aimed at ensuring the effective collection of taxes, except where this results in arbitrary discrimination. Finally, pursuant to article 21 (5), the ECT provision on expropriation remains applicable to taxation measures.
- Article XIV of the GATS states the following: “Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised

restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures [...] inconsistent with Article XVII, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes [...]”. According to article XIV (e), the same applies with regard to measures inconsistent with the MFN treatment obligation (article II), provided that the difference in treatment is the result of an agreement on the avoidance of double taxation.

In conclusion, all the IIAs mentioned above restrict the applicability of the treaty with regard to fiscal incentives. In particular, the principle of non-discrimination is either inapplicable or applies only to a limited extent.

d. Other exceptions

Article 10.8 of the ECT contains a review clause concerning specific incentives. Accordingly, the modalities of the application of the non-discrimination principle in relation to programmes under which a contracting party provides grants or other financial assistance, or enters into contracts, for energy technology research and development shall be reserved for a so-called “Supplementary Treaty”. Each contracting party shall, through the ECT Secretariat, keep the Charter Conference informed of the modalities it applies to such programmes. BITs sometimes contain similar provisions excluding non-discrimination obligations with regard to special advantages granted to development finance institutions established for the exclusive purpose of development assistance.⁵

In addition, the ECT contains other types of exception clauses concerning certain investment incentives. Pursuant to article 24.2 (b) (iii), the Treaty

“shall not preclude any Contracting Party from adopting or enforcing any measure [...] designed to benefit Investors who are aboriginal people or socially or economically disadvantaged individuals or groups or their Investments and notified to the Secretariat as such, provided that such measure (A) has no significant impact on that Contracting Party’s economy; and (B) does not discriminate between Investors of any other Contracting Party and Investors of that Contracting Party not included among those for whom the measure is intended, provided that no such measure shall constitute a disguised restriction on Economic Activity in the Energy Sector, or arbitrary or unjustifiable discrimination between Contracting Parties or between Investors [...]. Such measures shall be duly motivated and shall not nullify or impair any benefit one or more other Contracting Parties may reasonably expect under this Treaty to an extent greater than is strictly necessary to the stated end.”

A similar clause may be found in the 1997 BIT between Canada and Lebanon where a provision in Annex I excludes the application of several general disciplines (e.g. prohibition of non-discrimination, performance requirements) to any measures denying investors of the other contracting party and their investments any rights or preferences provided to the aboriginal peoples of Canada (section III, paragraph 5(c)).⁶

2. Incentives in conjunction with performance requirements

Host countries sometimes condition the granting of an incentive upon the fulfilment of certain performance requirements that are not prohibited by the WTO Agreement on Trade-Related Investment Measures (TRIMs Agreement), which is binding on all WTO

members.⁷ For example, they may demand from investors that they create a certain minimum number of jobs, establish the investment in a specific region or transfer a certain technology. In response to this issue, two categories of provisions can be distinguished in IIAs: provisions that prohibit the granting of incentives from being conditional upon the fulfilment of certain performance requirements; and provisions that exempt from the prohibition of performance requirements certain measures that are associated with the granting of an incentive.⁸

The most important instrument in respect of the first issue is the TRIMs Agreement. According to article 2 of the Agreement, no contracting party shall apply any trade-related investment measure that is inconsistent with the provisions of article III (obligation of national treatment) and article XI (obligation of general elimination of quantitative restrictions) of the GATT 1994. An annex to the TRIMs Agreement includes an illustrative list of prohibited measures. No member of the WTO can attempt to reverse the prohibition on the imposition of such performance requirements through the provisions of bilateral or regional IIAs that would be inconsistent with their obligations under the TRIMs Agreement.

An example of the second approach can be found in the 1994 model BIT of the United States as revised in 1998. Pursuant to its article VI, “[n]either Party shall mandate or enforce [performance requirements], as a condition for the establishment, acquisition, expansion, management, conduct or operation of a covered investment...”. However, according to the last paragraph of this article “[s]uch requirements do not include conditions for the receipt or continued receipt of an advantage”. This approach has been reflected, for example, in the United States BITs with El Salvador (1999), Bolivia (1998), Honduras (1995), Nicaragua (1995) and Trinidad and Tobago (1994).

Canada follows a similar approach. The Canadian BITs contain a clause that explicitly excludes the granting of subsidies and advantages from the prohibition to establish performance requirements. For instance, pursuant to article VI(2) of the Canadian BITs with Trinidad and Tobago (1996), Ecuador (1997), Panama (1998) and Barbados (1997), “[t]he provisions of Articles II, III, IV and V [performance requirements] of this Agreement do not apply to [...] subsidies or grants provided by a government or a state enterprise, including government-supported loans, guarantees and insurance; ...”⁹

A similar approach applies under the NAFTA. According to its article 1106, paragraph 3, no party may condition the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a party or of a non-party, on compliance with any trade-related requirements. However, the same article provides that “[n]othing in paragraph 3 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory”. Therefore NAFTA prohibits, consistent with the TRIMs Agreement, the conditioning of incentives to trade-related performance requirements, while permitting incentives that are linked to other types of requirements (so-called investment-related performance requirements).¹⁰

C. Transparency

The majority of IIAs that specifically address the issue of transparency do so in general terms. It is therefore not always clear whether the resulting transparency obligations extend to incentives. The usual formulation is to refer to laws, regulations, procedures and administrative practices of general application in respect to any matter

covered by the IIA in question, coupled with the obligation that these are promptly published or otherwise made available to interested parties (UNCTAD, forthcoming c). To the extent that incentives provisions are contained in such instruments, the transparency obligation extends to them as well. Beyond that, certain agreements make an explicit connection between incentives and transparency. Thus, the section on “Investment Incentives” in the draft MAI included a provision that expressly applied the transparency provision in the draft MAI to investment incentives.

In other instruments transparency in the operation of investment incentives is placed on a hortatory basis. Thus, the OECD Declaration on International Investment and Multinational Enterprises, paragraph IV (International Investment Incentives and Disincentives), states, *inter alia*, that member countries will endeavour to make measures concerning investment incentives and disincentives “as transparent as possible, so that their importance and purpose can be ascertained and that information on them can be readily available”. In a similar fashion, article 160 of the Treaty Establishing the Common Market for Eastern and Southern Africa addresses the need for the member States to “undertake to increase awareness of their investment incentives, opportunities, legislation, practices, major events affecting investments and other relevant information through regular dissemination and other awareness-promoting activities.”

The SCM Agreement contains mandatory, detailed transparency provisions dealing with incentives. For example, article 25 of this Agreement requires members to notify subsidies covered by the Agreement in order to enable other members to evaluate the trade effects and to understand the operation of the notified subsidy programmes. Article 22 also requires members to notify and make publicly available the initiation of an investigation on the legality of subsidy programmes of other members, providing clearly the types of information to be included in the public notice.

D. Addressing incentives competition

Competition over investment incentives may have several negative effects (UNCTAD, 1996a). It may also encourage host countries to adopt “race-to-the-bottom” policies or discourage them to undertake “race-to-the-top” policies. Incentives competition may also lead to distortions and misallocations of investment, thereby possibly compromising the potential effects of regional integration aimed at broadening the market. These effects may be addressed by, for example, prohibiting the lowering of regulatory standards or establishing international control or consultation mechanisms.

1. Limits on the lowering of regulatory standards

Provisions in this area cover either environmental or labour standards or combine them into a more comprehensive provision. Some agreements also include a reference to health and safety standards.

a. Environmental protection

Article 1114, paragraph 1, NAFTA, confirms the sovereign right of contracting parties to take measures necessary for the protection of the environment. Article 1114, paragraph 2, states that:

“[t]he Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request

consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement”.

NAFTA also contains a Side Agreement on Environmental Cooperation. Its objectives include the protection and improvement of the environment, the promotion of sustainable development, and the increase of cooperation between the parties. In the context of incentives, its Article 3 is of particular relevance. It reads as follows:

“Recognizing the right of each Party to establish its own levels of domestic environmental protection and environmental development policies and priorities, and to adopt or modify accordingly its environmental laws and regulations, each Party shall ensure that its laws and regulations provide for high levels of environmental protection and shall strive to continue to improve those laws and regulations.”

In a similar manner, article G.14 of the 1996 Free Trade Agreement between Canada and Chile states:

“1. Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.

2. The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an

encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that the other Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.”¹¹

Environmental measures have also been addressed in the 1994 Asia-Pacific Economic Cooperation (APEC) Non-Binding Investment Principles. They provide that “Member economies will not relax health, safety, and environmental regulations as an incentive to encourage foreign investment.”¹² Furthermore, the sixth recital of the preamble of the BIT between Bolivia and the United States emphasizes the agreement between the parties that the treaty’s objectives (i.e. the encouragement and reciprocal protection of investment) “can be achieved without relaxing health, safety and environmental measures of general application”.

b. Labour rights

This issue has been dealt with in international labour conventions. For example, paragraph 46 of the 1977 International Labour Organisation’s (ILO) Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (as amended in 2000) states the following:

“Where governments of host countries offer special incentives to attract foreign investment, these incentives should not include any limitation of the workers’ freedom of association or the right to organize and bargain collectively.”

In addition, there are several ILO Conventions/ Declarations establishing certain minimum social rights that member countries have to respect. Among the most important of these instruments are the 1998 Declaration on Fundamental Social Rights (ILO, 1998), and the 1999 Convention on the Worst Forms of Child Labour (ILO, 1999). The fundamental social rights include the freedom of association and the right of collective bargaining, the elimination of all forms of forced labour, the elimination of child labour, and the elimination of discrimination concerning work and profession.

NAFTA includes a Side Agreement on Labor Cooperation. Its objectives are, *inter alia*, to improve working conditions and living standards, to promote as much as possible the labour principles set out in Annex 1 of the Agreement, and to encourage cooperation between the Parties. Of particular importance in the context of incentives is article 2. It reads as follows:

“Affirming full respect for each Party’s constitution, and recognizing the right of each Party to establish its own domestic labor standards, and to adopt or modify accordingly its labor laws and regulations, each Party shall ensure that its labor laws and regulations provide for high labor standards, consistent with high quality and productivity workplaces, and shall continue to strive to improve those standards in that light.”

c. Joint approaches

A few IIAs address both environmental and labour standards.

The 2000 OECD Guidelines for Multinational Enterprises include a provision in the chapter on “General Policies” regarding regulatory incentives. Accordingly, “[e]nterprises should take fully into account established policies in the countries in which they operate, and consider the views of other stakeholders. In this regard, enterprises

should [inter alia] [r]efrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues”.

During the MAI negotiations, there was a broadly shared view that a provision, discouraging the lowering of labour and environmental standards to attract foreign investment, should be included. Various drafting suggestions were made. They focused around the following text:

“[The Parties recognise that it is inappropriate to encourage investment by lowering [domestic] health, safety or environmental [standards] [measures] or relaxing [domestic] [core] labour standards. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such [standards] [measures] as an encouragement for the establishment, acquisition, expansion or retention of an investment in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.]”

Recent free trade agreements concluded by the United States follow the joint approach by including provisions recognizing that it is inappropriate to encourage investment by weakening or reducing the protections afforded in domestic environmental and labour laws.¹³ However, these provisions employ hortatory language, such as:

“[...] each Party shall strive to ensure that it does not waive or otherwise derogate from, or offer to waive or

otherwise derogate from, such laws in a manner that weakens or reduces the protections afforded in those laws as an encouragement for trade with the other Party, or as an encouragement for the establishment, acquisition, expansion, or retention of an investment in its territory.”¹⁴

Incentives in the form of lowering regulatory standards are still a relatively new issue for IIAs. To the extent that IIAs deal with this matter, it appears that provisions concerning environmental standards are more frequent than rules on labour rights. In view of the ongoing debate about the effects of globalization, one can expect that the issue will gain further importance.

2. Establishment of international control or consultation mechanisms

The development of international disciplines on investment incentives remains a controversial issue, especially in relation to the policies of developing host countries, for whom the retention of flexibility in regulatory techniques, including the use of investment incentives, is a major concern. Notwithstanding this cautious approach, as explained in section I, a number of IIAs seek to control, or even prohibit, incentives and/or establish a consultation mechanism between the parties.¹⁵

This sub-section reviews the practice of international instruments in this area commencing with provisions that discourage the use of certain approaches to investment incentives and those that envisage regional harmonization of investment incentives, followed by a review of the only mandatory control instrument in this area, namely the SCM Agreement. Although primarily concerned with issues related to trade, the SCM Agreement is the most advanced international

instrument in this respect. Finally the section ends with a review of consultation provisions.

a. Discouraging certain approaches to the granting of incentives

Some instruments, while not legally binding, expressly advise against the use of certain approaches in the development of incentives policy. Thus, the World Bank Guidelines on the Treatment of Foreign Direct Investment (World Bank Guidelines), while encouraging home country incentives for the enhancement of investment flows to developing countries, at the same time discourage the granting of certain incentives. According to section III.9, nothing in the World Bank Guidelines suggests that a State should provide foreign investors with tax exemptions or other fiscal incentives. Where such incentives are deemed to be justified by the State, they may to the extent possible be automatically granted, directly linked to the type of activity to be encouraged and equally extended to national investors in similar circumstances. Reasonable and stable tax rates are deemed to provide a better incentive than exemptions followed by uncertain or excessive rates. As examined above, recent free trade agreements address the issue of regulatory incentives by discouraging especially the lowering of environmental and/or labour standards.

b. Regional harmonization

In order to avoid investment distortions and misallocations due to incentives competition and to preserve the potential effects of economic integration, CARICOM member countries envisage the regional harmonization of investment incentives. Article XIV of the Protocol Amending the Treaty Establishing the Caribbean Community (Protocol III on Industrial Policy), which inserts the new article 49 into the Treaty, provides that “Member States shall harmonise national incentives to investments in the industrial, agricultural and services

sectors”. In this regard, this provision grants to the Council for Finance and Planning (COFAP) the authority to formulate proposals for the establishment of regimes for the granting of incentives, which should be consistent with relevant international agreements.

c. Control mechanisms

The SCM Agreement distinguishes between prohibited, actionable and non-actionable subsidies. Only “specific” subsidies may fall into the categories of prohibited or actionable subsidies (see further UNCTAD, 2002b; Roessler and Valles, forthcoming).

- *Prohibited subsidies*. According to article 3, subsidies related to import/ export requirements (i.e. subsidies that are contingent upon export performance or upon the use of domestic over imported goods) are prohibited. This ban would likewise apply to investment incentives that are conditioned to the fulfilment of such requirements. In case of a dispute over these subsidies, article 4 provides for a detailed dispute resolution mechanism.¹⁶
- *Actionable subsidies*. These are subsidies that are not automatically prohibited. Most specific subsidies fall into this category. In case of an actionable subsidy, a member may invoke the WTO dispute-settlement mechanism pursuant to article 7 if a specific subsidy has adverse effects on its industry, causes nullification or impairment to its benefits under GATT or causes serious prejudice to its interests. Article 7 establishes a dispute resolution mechanism for “actionable subsidies” similar to the one existing for prohibited subsidies.¹⁷
- *Non-actionable subsidies*. Article 8 identifies a number of subsidies that are non-actionable, i.e. they are not subject to the WTO dispute-settlement mechanism. These are subsidies that are either not specific or that fall into one of the following categories: assistance for research activities conducted by firms or by higher education or research establishments on a contract basis with firms; assistance to disadvantaged regions within the territory of a member

given pursuant to a general framework of regional development and non-specific (within the meaning of article 2) within eligible regions; and assistance to promote adaptation of existing facilities to new environmental requirements imposed by law and/ or regulations which result in greater constraints and financial burden on firms. Article 8 applies only provisionally for a period of five years following the entry into force of the WTO Agreements. The Committee on Subsidies and Countervailing measures did not extend the application of this provision. As a result, all subsidies that are specific to certain enterprises are now actionable (Roessler and Valles, forthcoming).

The incentive rules of the European Union (EU) go beyond the SCM Agreement in that they prohibit subsidies that are contingent on certain import/ export requirements and any subsidy that may distort competition between member States and that affects trade between them. Thus their applicability to anti-competitive and/or trade distorting investment aids is clear (box II.2).

Box II.2. The EU experience in regulating State aid

The EU has attempted to coordinate policies in the area of State aid to reduce the risk of harmful competition within the Union. Under the Treaty of Rome, the European Commission operates controls over market-distorting, anti-competitive State aids to investment. State aid includes grants, loans and guarantees, tax exemptions and infrastructure projects benefiting identifiable users. Pursuant to Article 87:

/...

Box II.2 (concluded)

“any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market” (TEC, 1997, p. 73).

Not covered by this ban are government support measures of a general nature. This is the case if:

- there is no specificity in terms of sector, region or category;
- the eligibility of the aid is based on objective criteria, without any discretionary power of the authorities; or
- the measure is in principle not limited in time or by a predetermined budget.

However, the Commission may exempt the following State support from the prohibition:

- aid to promote economic development in poor regions;
- aid to promote an important project of common European interest or to remedy serious economic disturbance;
- aid to promote regional economic development, if it does not negatively impact other regions' trading positions;
- aid to promote cultural and heritage conservation; and
- other categories of aid as may be determined by the Council.

Much in this list may be of relevance to developing countries. Many of the above criteria are development related criteria, or emergency criteria that may well apply to the economic and social realities of the developing countries.

Source: UNCTAD.

d. Provisions on consultation or future negotiations

To address the possible distortive effects of incentives upon market conditions as related to investment, several instruments provide for mutual information and consultations between the parties. Some IIAs go one step further and stipulate that the parties shall enter into future negotiations in order to establish multilateral disciplines on incentives. Thus, Article XV of the GATS states that:

“Members recognize that, in certain circumstances, subsidies may have distortive effects on trade in services. Members shall enter into negotiations with a view to developing the necessary multilateral disciplines to avoid such trade-distortive effects. The negotiations shall also address the appropriateness of countervailing procedures. Such negotiations shall recognize the role of subsidies in relation to the development programmes of developing countries and take into account the needs of Members, particularly developing country Members, for flexibility in this area. For the purpose of such negotiations, Members shall exchange information concerning all subsidies related to trade in services that they provide to their domestic service suppliers.”

The OECD Declaration and Decisions on International Investment and Multinational Enterprises introduced consultations in the field of investment incentives and disincentives through a Ministerial Decision of May 1984. Such consultations take place at the request of a member country that considers that its interests may be adversely affected by the impact, on its flow of “international direct investment”, of measures taken by another member country that provides significant official incentives and disincentives to FDI. Having full regard to the national economic objectives of the measures and without prejudice to policies designed to redress regional imbalances,

the purpose of the consultations is to examine the possibility of reducing adverse effects to a minimum. The Business and Industry Advisory Committee (BIAC) and the Trade Union Advisory Committee (TUAC) may be periodically invited to express their views on these matters. It appears that, up to now, these procedures have never been used.

During the MAI negotiations, a suggestion was made concerning the treatment of investment incentives. The draft article provided for a consultation mechanism between contracting parties and for future negotiations on the establishment of legally binding rules on the granting of incentives. The draft provision reads as follows:

“1. The Contracting Parties confirm that Article XX (on NT and MFN) and Article XX (Transparency) applies to [the granting of] investment incentives.

2. [The Contracting Parties acknowledge that [, in certain circumstances,] even if applied on a non-discriminatory basis, investment incentives may have distorting effects on the flow of capital and investment decisions. [Any Contracting Party which considers that its investors or their investments are adversely affected by an investment incentive adopted by another Contracting Party and having a distorting effect, may request consultations with that Contracting Party.] [The former Contracting Party may also bring the incentive before the Parties Group for its consideration.]]

3. [In order to further avoid and minimise such distorting effects and to avoid undue competition between Contracting Parties in order to attract or retain investments, the Contracting Parties [shall] enter into negotiations with a view to establishing additional MAI

disciplines [within three years] after the signature of this Agreement. These negotiations shall recognise the role of investment incentives with regard to the aims of policies, such as regional, structural, social, environmental or R&D policies of the Contracting Parties, and other work of a similar nature undertaken in other fora. These negotiations shall, in particular, address the issues of positive discrimination, [transparency], standstill and rollback.]”

Recent free trade agreements addressing the issue of regulatory incentives (by discouraging the lowering of environmental and/or labour standards) make use of general cooperation and consultation mechanisms to deal with any matter arising under such provisions. For example, chapter 18 on Environment of the 2003 free trade agreement between Singapore and the United States includes language discouraging regulatory incentives (article 18.2) as well as general provisions requiring the pursuit of cooperative environmental activities (article 18.6) and consultation to resolve any matter arising under this chapter (article 18.7).

The above provisions consider incentives as an important investment issue that requires a policy dialogue between the parties concerned. However, some instruments also recognize that this might not be sufficient, and that the granting of incentives should be subject to additional rules. However, the conclusion of binding regional or multilateral disciplines controlling the availability of investment incentives as a policy tool, including simply increasing transparency, is controversial. There does not seem to be interest among either developed or developing countries to reach an agreement on the use of incentives beyond what is already addressed in the SCM approach.

E. Encouragement of development-oriented incentives

IAs can explicitly encourage or even require the use of incentives by host countries in order to pursue development policies. One possibility in this respect is to entitle host countries parties to regional agreements to offer, under certain conditions, incentives to certain categories of companies established in one of the contracting parties. This may include the harmonization of domestic incentives. Another approach addresses home country incentives (see further UNCTAD, 2003a, section VI). In this regard, some instruments encourage the granting of incentives by the home countries, with a view towards increasing FDI flows and their benefits for developing countries.

1. Host country incentives

Agreements that allow host countries to grant incentives have been concluded between developing country parties to regional agreements. For example, Decision 292 of the Commission of the Cartagena Agreement (article 12) provides that:

Andean Multinational Enterprises shall be eligible for export incentives under the same conditions contemplated for national companies in their respective sector, provided that they fulfil the requirements for said companies in the corresponding legislation. Likewise, Andean Multinational Enterprises may make use of the special systems for importation and exportation established in the national legislation of the Member Country of the principal domicile and of any branches.

This provision is reserved for the treatment of specialized regional enterprises established under the particular supranational regime of the Andean Multinational Enterprise.

On the other hand, certain agreements extend incentives to all classes of investors from within the region. Thus, article 4 of the 1981 Agreement on Promotion, Protection and Guarantee of Investments Among Member States of the Organisation of the Islamic Conference provides that “[t]he contracting parties will endeavour to offer various incentives and facilities for attracting capitals and encouraging its investment in their territories such as commercial, customs, financial, tax and currency incentives, especially during the early years of the investment projects, in accordance with the laws, regulations and priorities of the host state”. In a similar vein, the Protocol Amending the 1998 Treaty Establishing the Caribbean Community (CARICOM) (Protocol III: Industrial Policy) provides rules on the harmonization of investment incentives, including a positive statement to grant incentives to investors in specific sectors. The relevant provision, article XIV (inserting a new article 49 into the Treaty), reads as follows:

“1. Member States shall harmonise national incentives to investments in the industrial, agricultural and services sectors.

2. The COFAP shall, consistent with relevant international agreements, formulate proposals for the establishment of regimes for the granting of incentives to enterprises in the sectors mentioned in paragraph 1. In particular, such proposals shall accord support for industries considered to be of strategic interest to the Community.

3. In formulating the proposals mentioned in paragraph 2, the COFAP shall give due consideration to the peculiarities of the industries concerned and, without prejudice to the generality of the foregoing, may provide for the following:

- (a) national incentives to investment designed to promote sustainable, export-led industrial and service-oriented development;
- (b) investment facilitation through the removal of bureaucratic impediments; and
- (c) non-discrimination in the granting of incentives among Community nationals.”

A further example comes from the Customs and Economic Union of Central Africa. According to chapter I, section 1, of the Common Convention on Investments in the States of the 1965 Customs and Economic Union of Central Africa, any investment falling into one of the categories listed therein may benefit from a special decision admitting it to a preferential schedule. These categories mainly cover activities in the areas of agriculture, exploitation of natural resources, power production and tourism. The following criteria shall in particular be taken into consideration during the examination of the project: (a) importance of the investment, (b) participation in the implementation of the economic and social plans, (c) creation of employment and vocational training, (d) participation of nationals of the countries of the Union in the formation of capital, (e) use of technically guaranteed equipment, (f) priority use of local raw materials and, in general, local products and (g) registered office established in a country of the Union. Approved undertakings may benefit from various tax benefits and may be given priority in the granting of foreign currency in order to buy equipment goods and raw materials necessary for their operations. Pursuant to chapter II, undertakings of cardinal importance to national economic development, involving exceptionally high investments, may also be granted the stabilization of fiscal provisions. Chapter IV allows for the possibility that undertakings considered as being especially important to the social and economic development plans of the member country benefit from an establishment convention granting to them certain guarantees and imposing certain obligations. In addition to certain fiscal guarantees, the government may grant guarantees as to the

financial, legal and economic stability and stable conditions for financial transfers and the marketing of goods, guarantees as to the entry and movement of labour, freedom of employment, and the free choice of suppliers and services, and guarantees as to the renewal of lumbering and mining permits if necessary. This approach is echoed in article 23 of the Community Investment Code of the Economic Community of the Great Lakes Countries (CEPGL) which states that “[a]ny enterprise as defined under article 2 which meets the conditions for authorization under this Code may benefit from the economic, financial and tax advantages provided for under basic regime I as hereinafter established”. A similar approach has been taken with regard to tariff preference in the context of an ASEAN industrial joint venture according to the 1987 Revised Basic Agreement on ASEAN Industrial Joint Ventures (article III).

The above IIAs are based on the understanding that incentives can play a useful role and should therefore be permitted. At the same time, these IIAs – which are all regional agreements – seek to minimize the risk of investment distortions by establishing common principles for the granting of incentives. To this end, the IIAs identify categories of companies that are eligible for incentives or types of incentives that may be offered.

2. Home country incentives

Technical assistance, technology transfer requirements, financial and fiscal incentives and investment insurance provided by some home country governments for the purpose of encouraging investment in developing countries are recognized as positive instruments to encourage and promote FDI flows to developing countries (UNCTAD, 2001d, 2003a). While home country incentives are usually of a hortatory nature, encouraging firms from the home country to invest in developing countries, certain stronger commitments have also been used.

The only comprehensive, mandatory international agreement addressing the issue of home country incentives is the 2000 Partnership Agreement between the Members of the African, Caribbean and Pacific Group of States of the One Part, and the European Community and Its Member States, of the Other Part (the Cotonou Agreement), the successor to the Fourth Lomé Convention. The Cotonou Agreement includes several provisions on different types of home country incentives. The Agreement, for example, reaffirms the importance of technology transfer objectives by calling for cooperation in the “development of scientific, technological and research infrastructure and services; including the enhancement, transfer and absorption of new technologies” (article 23). More generally, the Agreement provides a list of investment promotion measures to be undertaken by the parties to the Agreement, including the home countries. Article 75 states that:

“The ACP States, the Community and its Member States [...] shall:

- (a) implement measures to encourage participation in their development efforts by private investors [...];
- (b) take measures and actions which help to create and maintain a predictable and secure investment climate as well as enter into negotiations on agreements which will improve such climate;
- (c) encourage the EU private sector to invest and to provide specific assistance to its counterparts in the ACP countries under mutual business cooperation and partnerships;
- (d) facilitate partnerships and joint ventures by encouraging co-financing;
- (e) sponsor sectoral investment fora to promote partnerships and external investment;
- (f) support efforts of the ACP States to attract financing, with particular emphasis on private financing, for

- infrastructure investments and revenue-generating infrastructure critical for the private sector;
- (g) support capacity-building for domestic investment promotion agencies and institutions involved in promoting and facilitating foreign investment;
 - (h) disseminate information on investment opportunities and business operating conditions in the ACP States;
 - (i) promote [...] private-sector business dialogue, cooperation and partnerships [...].”

The Agreement recognizes, moreover, the role that financing measures play in development objectives. Article 76 on “Investment finance and support” states that:

“Cooperation shall provide long-term financial resources, including risk capital, to assist in promoting growth in the private sector and help to mobilise domestic and foreign capital for this purpose. To this end, cooperation shall provide, in particular:

- (a) grants for financial and technical assistance to support policy reforms, human resource development, institutional capacity-building or other forms of institutional support related to a specific investment, measures to increase the competitiveness of enterprises and to strengthen the capacities of the private financial and non-financial intermediaries, investment facilitation and promotion and competitiveness enhancement activities; [...]
- (c) risk-capital for equity or quasi-equity investments, guarantees in support of domestic and foreign private investment and loans or lines of credit on the conditions laid down in Annex II “Terms and Conditions of Financing” to this Agreement; [...].”

Finally, the Cotonou Agreement affirms the importance of investment protection through investment guarantees. In this regard, article 77 of the Agreement states in part that:

- “1. Investment guarantees are an increasingly important tool for development finance as they contribute to reducing project risks and inducing private capital flows. Cooperation shall therefore ensure the increasing availability and use of risk insurance as a risk-mitigating mechanism in order to boost investor confidence in the ACP States.
2. Cooperation shall offer guarantees and assist with guarantees funds covering risks for qualified investment. [...]
3. Cooperation shall also provide support to capacity-building, institutional support and participation in the core funding of national and/ or regional initiatives to reduce the commercial risks for investors [...].
4. [...] The ACP and the EC will within the framework of the ACP-EC Development Finance Cooperation Committee undertake a joint study on the proposal to set up an ACP-EC Guarantee Agency to provide and manage investment guarantee programmes.”

Aside from the Cotonou Agreement, there are other IIAs that address the issue of home country incentives albeit not on such a comprehensively basis. Among the international agreements requiring home countries to grant incentives to promote technology transfers, the leading example is the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). According to article 66.2 of that Agreement, “[d]eveloped country Members shall provide incentives to enterprises and institutions in their territories for the purpose of promoting and encouraging technology transfer to least-developed country Members in order to enable them to create a sound

and viable technological base.” Although it does not specify what type of technology transfer is to be supported and how, this mandatory provision potentially strengthens the position of technology buyers in least-developed countries (UNCTAD, 2003a, pp. 131-134).

Certain intra-regional cooperation agreements between developing countries introduce various home country commitments to promote investment in host countries party to the agreement. For example, the Treaty Establishing the Caribbean Community differentiates between the more and less developed countries among its membership, establishing a special regime for financial assistance “with a view to promoting the flows of investment capital to the Less Developed Countries” (chapter VII, article 59(1)). The Agreement on Investment and Free Movement of Arab Capital Among Arab Countries endorses a policy in article 1(a) that “Every Arab state exporting capital shall exert efforts to promote preferential investments in the other Arab states and provide whatever services and facilities required in this respect” (see further UNCTAD, 2003a, chapter VI).

Furthermore, regional investment agreements among developing countries often contain provisions on fiscal incentives that guarantee tax-free asset transfers or provide reduced tax levels for qualifying preferred investors. In its formulation of a draft provision on the “promotion and encouragement of investments”, the Asian-African Legal Consultative Committee suggested under article 2(1) the use of “appropriate incentives, wherever possible, which may include such modalities as tax concessions and investment guarantees”. Tax-sparing provisions in double taxation treaties can alleviate the problem of home country taxation nullifying the FDI incentive effect of fiscal privileges granted to foreign investors by host countries. Many developed countries, with the notable exception of the United States, have been willing to accept tax-sparing provision in double taxation treaties signed with developing countries (UNCTAD, 2000c, p. 57). The International Chamber of Commerce (ICC) essentially endorsed tax-sparing

provisions in its 1972 Guidelines for International Investment, proposing under paragraph 2(e) of chapter IV that home country governments “should refrain from frustrating the effects of development reliefs granted by host countries in respect of new investment by affording appropriate matching reliefs” (UNCTAD, 2001d, pp. 36-37).

The World Bank Guidelines suggest that developed and capital surplus States should not obstruct flows of investment from their territories to developing countries; rather, they are encouraged to adopt appropriate measures to facilitate such flows, including taxation agreements, investment guarantees, technical assistance, and the provision of information (section III.10).

* * *

This section has highlighted the variety of provisions that exist in IIAs covering investment incentives, and investment-related trade incentives. Outside the trade field, these are not very comprehensive and fall short of a developed international code on incentives. Nonetheless, a certain level of control already exists through the general non-discrimination provisions common to most IIAs. However, governments remain relatively free to use investment incentives, subject to non-discrimination standards (to which a number take exceptions) and to their obligations as members of the WTO under the TRIMs and SCM Agreements. Whether future IIAs will contain more developed rules on incentives is open to discussion. These could go in a number of directions, from a positive encouragement of what may be seen as development friendly incentives, offered not only by host, but also by home countries, to increased controls over incentives. In this process, consultation and exchanges-of-information mechanisms over incentive policies and their effects may become stronger.

Notes

- ¹ See further Daly, 1998.
- ² Unless otherwise noted, all instruments cited herein may be found in UNCTAD, 1996c, 2000b, 2001f, 2002a and forthcoming a; the texts of the BITs mentioned in this paper may be found in the collection of BITs maintained online by UNCTAD at www.unctad.org/ia.
- ³ Similar provisions are also contained in Annex I of the 1997 BIT between Canada and Lebanon (section III, paragraph 5(b)).
- ⁴ See e.g. 1994 BIT between Indonesia and Malaysia (article III).
- ⁵ See the 1998 BIT between Chile and South Africa (article IV, paragraph 4) and the 1995 BIT between South Africa and The Netherlands (article 4, paragraph 4).
- ⁶ See also a provision in the BIT between Mauritius and South Africa granting parties the freedom to adopt "any law, the purpose of which is to promote the achievement of equality in its territory, or designed to protect or advance persons, or categories of persons, disadvantaged by unfair discrimination in its territory" (article 3, paragraph 4(c)).
- ⁷ In this context, it should be noted that Argentina, Colombia, Malaysia, Mexico, Pakistan and Thailand were granted extensions to their transitional period for compliance with the TRIMs Agreement until 31 December 2003, the Philippines until 30 June 2003 and Romania until 31 May 2003 under the provisions of article 5.3 of the TRIMs Agreement. Performance requirements are analysed broadly in UNCTAD, 2001c. For a recent study of the effects of performance requirements, see UNCTAD, 2003b.
- ⁸ See further Guisinger and Associates, 1985.
- ⁹ See in this regard also the free trade agreements between Mexico and Costa Rica (1994, article 13-06), between Mexico and Nicaragua (1992, article 16-05) and between Mexico and Chile (1998, article 9-07); also the 1990 Free Trade Agreement between Colombia, Mexico and Venezuela (article 17-04) and the 1988 Free Trade Agreement between Canada and the United States (article 1603).

- ¹⁰ In a spirit similar to that of the NAFTA, the draft MAI did not preclude a party from conditioning the receipt or continued receipt of an advantage, in connection with “an investment in its territory of an investor of a Contracting Party or of a non-Contracting Party...” on compliance with a number of listed requirements, commitments or undertakings.
- ¹¹ Note however, that the 1996 Free Trade Agreement between Canada and Chile has been supplemented by the 1997 Agreement on Environmental Cooperation and an Agreement on Labour Cooperation.
- ¹² For other examples of IIAs dealing with this type of environmental regulatory restrictions, see the free trade agreements between Mexico and Costa Rica (1994, article 13-16), between Mexico and Nicaragua (1992, article 16-14) and between Mexico and Chile (1998, article 9-15); also the 1990 free trade agreement between Colombia, Mexico and Venezuela (article 17-13).
- ¹³ See the 2003 free trade agreement between Chile and the United States (articles 18.2 and 19.2) and 2003 free trade agreement between Singapore and the United States (articles 17.2 and 18.2). See also the 2003 model BIT of the Belgian-Luxemburg Economic Union (articles 5 and 6).
- ¹⁴ Article 18.2 of the 2003 free trade agreement between Singapore and the United States.
- ¹⁵ In this regard, reference should be made to the 2003 OECD’s checklist on FDI incentives agreed upon by the Committee on International Investment and Multinational Enterprise to serve as a tool to assess the costs and benefits of using incentives to attract FDI (UNCTAD, 2003a, pp. 127-128).
- ¹⁶ Pursuant to article 27.1, members recognize that subsidies may play an important role in the economic development programmes of developing member countries and thus the SCM Agreement contains a number of significant exceptions/ modifications to the “normal” WTO regime on subsidies. The prohibitions concerning export/ import-related subsidies (article 3) do not fully apply to developing countries:
- As far as subsidies for export performance are concerned (article 3.1 (a)), Annex VII of the SCM Agreement lists a number of developing countries for which the prohibition shall not apply. These are the least-developed countries as designated by the United Nations. According to article 27.2(b), other developing countries are exempt from the prohibition for a period of eight years from the date of entry

into force of the WTO Agreement (i.e. until 1 January 2003). For the following countries, the obligation to respect the prohibition after eight years applies only once the annual gross national product (GNP) per capita has reached \$1,000: Bolivia, Cameroon, Congo, Côte d'Ivoire, Dominican Republic, Egypt, Ghana, Guatemala, Guyana, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka and Zimbabwe (see Annex VII of the SCM Agreement). According to article 27.4, further extensions may be granted where it is necessary to apply such subsidies (see the "Procedures for Extensions under Article 27.4 for Certain Developing Country Member" adopted by the SCM Committee on 20 November 2001, WTO document G/SCM/39 and subsequent decisions by the SCM Committee).

- With regard to subsidies concerning import substitution (article 3.1 (b)), the prohibition did not apply to developing countries for a period of five years from the date of entry into force of the WTO Agreement (i.e. until 1 January 2000). For the least developed countries, the period was eight years (i.e. until 1 January 2003).

¹⁷ Special provisions for developing countries also exist with regard to actionable subsidies. According to article 27.8, there shall be no automatic presumption that certain subsidies granted by a developing country (i.e. those listed in article 6.1) result in serious prejudice. Rather, such prejudice needs to be demonstrated. With regard to other actionable subsidies (i.e. those where not even article 6 provides for an automatic presumption of serious prejudice), article 27.9 establishes less stringent dispute-settlement procedures. Furthermore, according to article 27.13, none of the WTO provisions on actionable subsidies shall apply to direct forgiveness of debts or subsidies to cover social costs when such subsidies are granted in the framework of a privatisation programme of a developing country. Both such a programme, and the subsidies involved, need to be granted for a limited period and notified to the Committee, and the programme needs to result in eventual privatisation of the enterprise.

Finally, article 29 granted exemptions for transition economies. Members in the process of transformation from a centrally planned into a market, free-enterprise economy could apply programmes and measures necessary for such a transformation. For such members, subsidy programmes falling within the scope of prohibited subsidies and notified accordingly had to be

phased out or brought into conformity with the SCM Agreement within a period of seven years from the date of entry into force of the treaty (i.e. until 1 January 2002). In exceptional circumstances, the Committee may permit to those members departures from their notified programmes, measures and their time frame if such departures are deemed necessary for the process of transformation.

Section III

INTERACTION WITH OTHER ISSUES AND CONCEPTS

This section examines and explains how the issue of incentives interacts with other issues and concepts commonly found in IIAs. Table III.1 shows the range of interaction with the most common investment issues. The most important interactions concern the issues of admission and establishment, home country measures, host country operational measures, MFN treatment, national treatment, state contracts, taxation and transparency.

Table III.1. Interaction across issues and concepts

Issues	Incentives
Admission and establishment	++
Competition	+
Dispute settlement: investor-State	0
Dispute settlement: State-State	0
Employment	+
Environment	+
Fair and equitable treatment	+
Home country measures	++
Host country operational measures	++
Illicit payment	0
Investment-related trade measures	+
Modalities and implementation	0
MFN treatment	++
National treatment	++
Scope and definition	0
Social responsibility	+
State contracts	++
Taking of property	+
Taxation	++
Transfer of funds	0
Transfer of technology	+
Transfer pricing	0
Transparency	++

Source: UNCTAD.

Key:

0	=	negligible or no interaction.
+	=	moderate interaction.
++	=	extensive interaction.

- **Admission and establishment.** Incentives may be granted to encourage foreign investors to make an investment in a host country. To the extent that IIAs include rules on admission and establishment of foreign investors, they may apply to such incentives. Indeed, the availability of incentives may be made conditional on the investor complying with certain conditions of entry specified at the point of entry. The scope of a host country's discretion in the granting of incentives at this stage will depend on the extent of its treaty obligations in applicable IIAs. Thus, where the host country accords pre-entry rights to investors, the range and availability of incentives will need to accord with general standards of treatment and guarantees given to investors under such an agreement. On the other hand, where the relevant IIA applies only to the post-entry phase, the host country retains considerable discretion to design its FDI incentive programme, as treatment of investors at the point of entry would fall outside the coverage of the IIA (see further UNCTAD, 1999a).
- **Home country measures.** The issue of incentives has a strong potential for interaction with home country measures. As discussed in section II, some agreements have provisions encouraging or requiring home developed countries to take active steps in promoting outward direct investment in host developing countries by firms from such home countries. The value of such provisions lies in the enhancement of investment conditions in developing host countries, to the extent that investment costs can be mitigated through financial support, technical assistance investment, risk insurance and other support measures provided by home countries (UNCTAD, 2001d, 2003a). In addition, such provisions in IIAs can serve to place home country measures on a footing of greater transparency, stability and security than unilateral measures of this kind, which tend to be offered at the discretion of the home country concerned. Indeed, where such measures are based on positive legal duties they can add to the development effect of an IIA by

coordinating host country obligations to guarantee certain investor rights with home country commitments to offer support to investors. This may encourage investment in host developing countries and increase the likelihood that such countries benefit more fully from it (see further UNCTAD, 2003a, chapter VI.A). Even where commitments to home country measures are hortatory in nature, positive effects could ensue in that they can serve to create a more investment friendly environment of cooperation between parties to the agreement in question, from which stronger obligations could grow over time.

- **Host country operational measures.** Host country operational measures include all measures implemented by host countries concerning the operation of foreign affiliates inside their jurisdictions. They usually take the form of either restrictions or performance requirements (UNCTAD, 2001c, p. 57). The fulfilment of such requirements may be a condition for the granting of incentives. For example, a host country might offer incentives in order to encourage the transfer of technology into its territory. IIAs may deal with this issue in the context of host-country operational measures. Equally, investment-related trade measures, such as export financing programmes or export processing zones, can also function as an incentive for attracting export-oriented FDI (UNCTAD, 1999b, pp. 5-7). The objective behind such kinds of policies may be to balance the aim of attracting internationally mobile investment, through the use of incentives, with a degree of conditionality imposed through host country operational measures, with a view to encouraging investors to contribute as much as possible to national development objectives.
- **National treatment/MFN treatment.** As discussed in section II, the principle of non-discrimination is central to the treatment of incentives in IIAs.

- **State contracts.** An incentive may be granted on the basis of an individual investment contract concluded between an investor and a host country, as is often the case in connection with major investment projects. Incentives in State contracts may not only include fiscal and financial aid, but likewise regulatory incentives. The State party to a contract may establish a special legal regime for the investment in the contract that is more favourable to the investor than the “normal” regulatory framework. Such preferential treatment may include stabilization clauses according to which the State party commits itself for example not to amend existing legislation to the disadvantage of the foreign investor. The failure by a host country to provide the incentive in accordance with the terms of the contract would constitute a breach of its contractual obligations. In addition, foreign investors might be protected under an IIA. It may include a provision according to which each contracting party will respect any other commitment (i.e. a commitment other than those in the IIA) it has entered into with regard to an investment of an investor of another contracting party. This means that the breach of the individual investment contract would become a violation of the IIA.

In addition, the issue arises whether the principle of non-discrimination applies to incentives granted under an investment contract. IIAs do not explicitly address this question. The application of the non-discrimination principle could mean that a host country that has promised an incentive in an investment contract to one investor is obliged also to grant incentives in other investment contracts that it concludes. Such an outcome might, however, be in contradiction to the principle of freedom of contract. In addition, even if the non-discrimination principle applied, foreign investors may find it difficult to prove that they are in like circumstances to the competitor who initially received the incentive (UNCTAD, forthcoming b).

- **Taxation.** Fiscal incentives are among the most commonly used types of incentives. Their underlying purpose is to reduce the effective tax rate applicable to foreign investment, thus increasing its rate of return (UNCTAD, 1996a). The applicability of IIAs with regard to fiscal incentives is usually very limited (see further UNCTAD, 2000c). The principal provisions of IIAs as they relate to fiscal incentives have been already considered in section II above.
- **Transparency.** As highlighted in section II, transparency is of crucial importance in the context of incentives, and some IIAs contain express provisions on this matter (UNCTAD, forthcoming c).

CONCLUSION: ECONOMIC AND DEVELOPMENT IMPLICATIONS AND POLICY OPTIONS

A. Economic and development implications¹

Incentive packages have been justified on the grounds that the attraction of one or a few “flagship” firms would signal to the world that a location has an attractive business environment and lead other investors to follow. From a dynamic perspective, incentives can reflect potential gains that can accrue over time from declining unit costs and learning by doing. They can also compensate investors for other government interventions, such as performance requirements, or correct for an anti-export bias in an economy arising from tariffs or an overvalued exchange rate. And they can compensate for various deficiencies in the business environment that cannot easily be remedied (UNCTAD, 1996a, pp. 9–11).

On the other hand, countries give incentives in order to benefit from FDI. This can be done by using incentives to influence firm behaviour with a view to achieving objectives related to development, or to correct for the failure of markets to capture wider benefits from externalities of production. Such externalities, which may be the result of economies of scale, the diffusion of knowledge or the upgrading of skills, may justify incentives to the point that the private returns equal the social returns.

The use of locational incentives to attract FDI has considerably expanded in frequency and value. The widespread and growing incidence of both fiscal and financial incentives is well documented until the mid-1990s (UNCTAD, 1996a; Moran, 1998; Oman, 2000). Anecdotal evidence since then suggests that this trend has continued (UNCTAD, 2002b; Charlton, 2003). In general, developed countries and economies in transition frequently employ financial incentives, while developing countries (which cannot afford a direct drain on the government budget) prefer fiscal measures (UNCTAD, 1996a, 2001g).²

The expanded use of incentives reflects more intense competition, especially between similar and geographically proximate locations. Governments seeking to divert investments into their territories often find themselves part of various “bidding wars”, with investors playing off different locations against each other, leading them to offer ever more attractive incentive packages to win an investment. Bidding wars are typically regional or local, reflecting competition between different countries, or between regions, provinces or cities within a country. For example, in the United States, more than 20 states have sometimes competed for the same FDI project, and more than 250 European locations competed for a BMW plant, which in 2001 ended up in Leipzig, Germany. For developing countries and economies in transition, bidding wars have been documented, for example, in Brazil and among ASEAN countries, among provinces of China as well as in the Central and Eastern European countries (Charlton, 2003).

An emerging trend in certain industries, in which investment projects can be located anywhere, is that competition over investment incentives has become global, adding a new layer to such competition.³ A further consequence of global investment competition has been the increased use of regulatory concessions, frequently used in export-processing zones. Such zones often create “policy enclaves” in which the normal regulatory rules and practices of the host country may not apply to reduce investment costs.

There is a long-standing debate on the economic benefits of locational incentives (UNCTAD, 1996a; Charlton, 2003). Do they distort the allocation of resources (and so reduce global welfare, including that of developing countries)? And do their costs to particular host countries offset their benefits? They may be economically justifiable if they offset market failures—that is, if they allow a host country to close the gap between social and private returns,⁴ to overcome an initial “hump” in attracting a critical mass of FDI or a

flagship investor that attracts other investors or to attract investors to efficient but otherwise little known locations.

Locational incentives can be economically inefficient if they divert investment from other locations that would have been selected on economic grounds. And once an incentive ends, the investor may move on if the underlying cause for poor competitiveness still persists. If the offer of incentives by one country leads to a “bidding war” for FDI, host countries lose to the TNC (or to its home country, if it can tax away the concessions). If incentives are used to address market failures, the first best policy may often be to correct the failure rather than to compensate for it; for example, if an incentive intends to overcome an overvalued exchange rate, it may be better to realign the currency than to add a new distortion through the incentive. Moreover, if an incentive tries to offset a decline in the locational advantages of a country (such as rising wages in a labour-intensive activity), it just delays adjustment at considerable cost to the taxpayer.

Another problem is that the asymmetry between developed and developing countries can bias FDI flows, at least where they compete for the same investment. Rich countries can afford to offer more incentives, and in more attractive (upfront grant) forms, than poorer countries. In other words, the richer can out-compete the poorer, or force them into an expensive competition for FDI projects.

Next comes the issue of whether locational incentives are effective in attracting significant new FDI. It is generally accepted that location incentives are seldom the main determinant of location decisions by TNCs. But where all else is equal, incentives can tilt the balance in favour of a particular location. This is most likely for export-oriented projects seeking a low-wage location in export-processing zone facilities, where many host countries offer similar conditions and other attributes (UNCTAD, 1996a, 2001g; Wells et al., 2001; Morisset and Pirnia, 2001).

Still, some evidence suggests that locational incentives have become more important as the mobility of firms has increased. Econometric studies that previously found incentives ineffective now find that they have become more significant determinants of FDI flows (Clark, 2000; Taylor, 2000).⁵ For domestic market-seeking or natural resource-seeking FDI, however, locational incentives are not as important—and they are harder to justify. More generally, there is an emerging consensus among economists that countries should try to attract FDI not so much by offering incentives but by building genuine economic advantages (and offering stable and transparent tax rates). Incentives should not be a substitute for building competitive capabilities. Many governments realize that incentive competition can be costly (particularly against better-endowed rivals).

Activity-specific and behavioural incentives are generally considered more effective. Export subsidies have been frequently used to promote export-oriented FDI, particularly in export-processing zones (UNCTAD, 2002b). Incentives to encourage foreign affiliates to increase employee training and assistance to local suppliers seem to have worked well in Hungary, Malaysia, Republic of Korea, Singapore and South Africa (UNCTAD, 2001b, 2003b). But this does not mean that they should be used indiscriminately. Some incentives can be wasted if foreign affiliates would have undertaken the activity anyway, or if they would have been happy with much smaller incentives. Yet even generous incentives may not have much effect if the setting is wrong. For example, research and development incentives are unlikely to raise affiliate spending on research and development in an economy without the local capabilities and technical skills to undertake design and innovation. In general, incentives alter slightly the ratio of benefits to costs of a particular activity—they cannot change it dramatically.

For regulatory concessions, labour and environmental standards are sometimes lowered in export-processing zones to attract FDI. Wages on average tend to be higher in the zones than in the rest of the

economy, but working conditions are at times affected by lax labour, safety and health regulations. Trade unions are often barred from organizing to improve those conditions (ILO, 1998; UNCTAD, 1999e, box IX.5). But there is no systematic evidence suggesting that lowering standards helps to attract quality FDI. On the contrary—the cost of offering regulatory concessions as incentives is that countries may find themselves trapped on a “low road” of cost-driven competition involving a race to the bottom in environmental and labour standards.

Countries that pursue more integrated approaches for attracting export-oriented FDI—placing FDI policies in the context of their national development strategies and focusing on productivity improvements, skills development and technology upgrading—have tended to attract higher quality FDI. Ireland and Singapore have pursued such integrated policy approaches, and both made efforts to promote training, facilitate dialogue between labour and management and provide first-class infrastructure for investors. They have demonstrated that good labour relations and the upgrading of skills enhance productivity and competitiveness (UNCTAD, 2002b).

In sum, incentives can be effective in attracting and influencing the location and behaviour of TNCs. But the economic desirability of locational incentives is not clear, particularly if they detract from building competitive capabilities and encourage bidding wars. The case for incentives at the site, activity and behavioural level is stronger, but only when the setting is appropriate. To increase the chances of efficiently applying both locational and behavioural incentives, governments also use “claw back” provisions that stipulate the return of incentives awarded if conditions are not met.⁶ Moreover, behavioural incentives are more likely to be effective in inducing benefits from FDI when complemented with other policy measures aimed, for example, at enhancing the level of skills, technology and infrastructure quality.

B. Policy options: alternative approaches and formulations

The above overview has shown that international instruments deal with incentives in different ways. Parties to an IIA have various choices. The concrete option that a country chooses depends on the general policy that it pursues vis-à-vis attracting FDI and benefiting from it, and the role that it accords to incentives in the framework of its development strategies.

Against this background a number of choices present themselves as to the form and content of IIA provisions relating to incentives. The discussion begins with the prevailing approach, namely, the omission of provisions dealing with incentives in IIAs. The discussion continues by highlighting a number of further options that may arise should countries decide to include rules on incentives in an IIA. These are discussed in an order that considers, first, the issue of definition; second, the types of provisions that could be employed to preserve governmental discretion in the use of incentives through exclusions to the non-discrimination principle; third, linking incentives and performance requirements; fourth, provisions on transparency; fifth, provisions addressing incentives competition by limiting the lowering of regulatory standards; and sixth, by establishing an international regime of policy co-ordination over incentives; and finally, provisions that seek to encourage development-oriented incentives.

Option 1: No specific rules on incentives

The most important effect of this option is that the principle of non-discrimination may apply to the granting of incentives. Through this policy, contracting parties confirm not to treat foreign investors less favourably with regard to incentives than their domestic counterparts or other foreign investors. It reflects the actual practice followed by most countries, namely, not to differentiate in their incentive programmes between domestic and foreign investors or between different foreign

investors, in accordance with the national treatment and MFN principles.

There is the issue of how the principle of non-discrimination would relate to a host country's economic and development strategies. Host countries would retain the right to develop and apply their incentive programmes. In particular, they would not be impeded from granting aid to investments in specific economic sectors, regions or to certain categories of investments, provided that they do not infringe on the national treatment and MFN standards. In addition, investors claiming non-discriminatory treatment would have to prove that they are "in like circumstances" as those investors who actually receive the incentive. This gives host countries considerable discretion in conducting their development policies in that a number of factors need to be taken into account when deciding what constitutes "like circumstances", including the relevant business sector, relative firm size and geographical location. Furthermore, host countries would, in principle, remain free to grant incentives in State contracts with individual investors.

Option 2: Specific provisions on incentives

Option 2(a): Definition of incentives

As noted in section II, most IIAs do not define this term as they do not cover the issue. Even those that refer to "subsidies", such as the GATS and NAFTA, have not defined that term. On the other hand, the SCM Agreement offers a comprehensive trade-oriented definition. But it too does not deal with certain questions relevant to investment incentives, notably the lowering of regulatory standards. Thus there is little precedent as to how to deal with this important matter. The choice lies in essence between a wide definition that covers all possible types of incentives and a narrower definition that covers only certain types of incentives. In the latter instance, the criteria for selection may include

whether to cover both general and specific incentives, or only one type or the other; whether or not to cover financial, fiscal and other (including regulatory) incentives or only some of these; and whether to cover only direct assistance from governmental sources or to include non-governmental assistance as well.

Option 2(b): Exclusions from the non-discrimination principle

The principle of non-discrimination might, in certain circumstances, impede the discretion of host countries to reserve incentives for their domestic investors only. This may be dealt with by way of a country-specific exception to national treatment, should the IIA in question offer such a choice. A host country that wants to adopt exceptions has several alternatives. For example, it may design a limited list of domestic companies or industries to which it wants to grant preferential treatment concerning incentives. Likewise, a host country may decide that only specific incentive programmes should be exempted from the non-discrimination principle. However, these options have the disadvantage that they are static and may not allow taking into account possible future changes in the incentive schemes. Another possibility is to include into an IIA a phase-out provision concerning the preferential treatment of domestic companies. Foreign investors could therefore claim non-discriminatory treatment with regard to incentives once this transition period has expired. This option might be preferred by developing countries seeking, in particular, to assist their infant enterprises. To this end, they may wish to take over fully or partially their start-up costs and terminate incentives once the infant industries have matured.

As noted in section II, many IIAs exempt taxation matters from the application of the treaty. The possible options range from a complete exclusion of taxation to more limited approaches, such as the non-application of the MFN treatment or national treatment obligations in respect of advantages granted in an agreement on the avoidance of

double taxation. These limitations could likewise cover fiscal incentives. Host countries opting for this alternative would therefore have the right to support their domestic investors by reserving fiscal benefits exclusively to them. Preferential tax treatment may, particularly, be an option for developing countries that do not have the financial means for other kinds of incentives (e.g. cash grants). It needs to be underlined, however, that the special treatment of taxation issues in IIAs is not intended to allow for discrimination against foreign investors. Rather, this approach reflects the wish of governments to deal with international taxation matters predominantly or exclusively in taxation agreements, thereby avoiding possible conflicts between these types of treaties and IIAs.

Option 2(c): Linking incentives to performance requirements

As noted in section II, host countries may condition the award of incentives upon the fulfilment of certain performance requirements by investors. This is, as noted above, subject to the limits placed upon host country discretion by adherence to the TRIMs Agreement, which prohibits outright certain types of performance requirements. On the other hand, outside such prohibited requirements, host countries remain free to pursue such a linkage policy in IIAs, subject to other international agreements they have concluded. The main development effect of such an approach is to allow for some direction as to the manner in which an investor can operate their investment, with the aim of enhancing its development effects. Hence the emphasis may be on requirements that enhance the transfer of technology, encourage “spill over” effects of technology and good business practice to domestic firms, promote employment and ensure adequate investment in less developed regions of the host country. This could be seen as the “price” to be paid for access to incentives. However, the linking of incentives to such requirements could also act as a disincentive for investors, where they may be seen as imposing excessive compliance costs upon firms, thereby making the host country location less attractive than one where

fewer or no such requirements are imposed. Thus host countries need to weigh up carefully the projected positive development effects of performance requirements combined with incentives against the possible disincentive to investment that such conditionality might introduce.

On the other hand, in order to discourage the potentially distorting effects of such linkage, countries may decide to include provisions in IIAs restricting their discretion to offer such conditional incentives. This may be done in at least two alternative ways. First, following the example of the TRIMs Agreement, through the prohibition of import or export-related performance requirements and incentives connected to them. By contrast, host countries continue to have the right to impose non-trade related performance requirements (e.g. research and development requirements, minimum level of domestic employment). Secondly, host countries could clarify the extent to which they restrict their power to condition the granting of incentives upon performance requirements. To this purpose, they could include a list of prohibited performance obligations in the IIA.

Option 2(d): Transparency

Host countries wishing to improve transparency could do so by establishing transparency obligations in IIAs that explicitly cover incentives. Host countries would commit themselves to publish or make otherwise publicly available information about their incentive programmes. Investors would therefore have the possibility of informing themselves as to what programmes are available and under what conditions they would be eligible to take advantage of them. This approach could also be followed at the regional level, including through incentive reviews (UNCTAD, 1995, p. 302).

There arises the further difficult issue of whether a transparency obligation would extend to incentives granted in individual investment

contracts. Whatever the answer to that question may be, host countries have the possibility of publishing investment contracts on a voluntary basis, provided that the investors parties to the agreements agree. It is not clear whether such contracts can be considered as having the character of a “law or regulation”, thereby raising a degree of uncertainty as to whether the transparency obligation covers such instruments.

Option 2(e): Addressing incentives competition by limiting the lowering of regulatory standards

As noted in section I, countries may hold the view that certain social, health, labour and environmental conditions are an integral part of their development strategies. Such countries may, however, be concerned that other countries could undermine their efforts by seeking to lower standards of protection in these areas thereby possibly diverting FDI flows and causing so-called “social/environmental dumping”. Such behaviour could weaken the formers’ position in the global competition for FDI, and could result in a “regulatory chill”. To diminish the risk of this type of incentives competition, countries would have the option of including, in an IIA, a clause prohibiting the lowering of standards in the designated regulatory fields as an instrument to attract FDI. Equally, a legally non-binding political declaration on the avoidance of lowering regulatory standards to specific investments or investors could be adopted. Contracting parties could also commit themselves to work towards a constant improvement of standards to protect environment and labour rights. One example of such an approach is the NAFTA where this commitment has been made in the form of “Side Agreements”.

Option 2(f): Addressing incentives competition by establishing international control or consultation mechanisms for the granting of incentives

Another option to address the negative effects of incentives competition is for countries to deal comprehensively with incentives in IIAs. One approach would be to establish a mutual information or consultation mechanism, especially for locational incentives. It could be invoked if a contracting party were of the opinion that incentives granted or considered by another contracting party could have a negative impact on its own competitive position. Since competition for FDI can involve many countries, it may be the case that such information or consultation efforts would need to be undertaken at a regional or even global level in order to be effective. Although IIAs have not, to date, explicitly prohibited the use of incentives through, for example, a blanket ban on the granting of advantages to investors, certain approaches aimed at dealing with incentives can be envisaged on the basis of international and national practices.

a. Conditional incentive-limitation clause

One option would be for governments to include in their IIAs a conditional incentive-limitation clause that would only become operative if a specified number or set of countries adopted the same clause. For example, a developing country facing its stiffest competition from, say, four neighbouring countries, could be reluctant to accept a bilateral discipline on incentives on its own, but might be willing to abide by such a discipline if its competitors had also agreed to such a clause. In this example, bilateral treaties would not have to be negotiated simultaneously; clauses would be activated only upon the signing of the required minimum number of treaties. Such an approach might be more promising if the principal home countries were to agree on a common incentive-limitation clause that each would insert into its model treaty (UNCTAD, 1995, p. 302).

b. Limiting the amount of financial assistance available through incentives

A further method of controlling or limiting the operation of incentives may be to set upper limits on the amount of financial assistance that a host country can give to foreign investors in an IIA. This could help avoid “incentives races” by limiting the final amount that a country could offer to an investor. On the other hand, this would also raise significant questions concerning the definition of an “incentive”, as a narrow definition could permit considerable discretion in the avoidance of the limit through the use of devices not normally considered incentives but which could have the same economic effect as an incentive, as discussed in section I above. Equally, there may be difficulties in determining the applicable limits, and the criteria by which these are to be set. A further option may be for governments to agree on criteria to discontinue gradually some of the most distorting incentives and, based on the agreed-upon criteria, to make the granting of incentives subject to approval by a regional or multilateral entity (UNCTAD, 1995). The discouragement of economically harmful incentives is a policy that would be attractive to countries that wish to control the amount of public expenditure on FDI projects and to limit their discretion in such fields so as to enhance the operation of market forces in investment decisions. Other countries may prefer to preserve their discretion in these matters.

c. Limiting incentives to essential social and economic objectives

Following the example of the European Union state aid provisions, briefly discussed in box II.2, an IIA may restrict the award of incentives to those cases in which an overriding social need (for example, the provision of essential infrastructure) or economic exigency (for example, the need to regenerate an economically underdeveloped

region or other identifiable entity) requires a level of economic risk reduction to ensure that the required investment takes place.

A variation of this approach is to make the grant of incentives to foreign investors conditional upon the unavailability of sufficient private sector finance to make the project viable in the absence of public sector subsidy. Where private sector finance is available, the foreign investment in question most probably does not require a public subsidy given that the rate of return on the investment would be sufficient to attract private investment capital. However, certain investments, that may be highly desirable from a social, economic and developmental perspective, may offer too lengthy a period of return to generate sufficient private sector interest. In such cases it may well be important for the government to underwrite part (in exceptional cases possibly all) of the investment capital required for the investment. This could be made subject to the fulfilment of performance targets so that the risk of wasted subsidy can be minimized (see further Muchlinski, 1999, chapter 7).

d. Checklist of FDI incentives

The evaluation of incentives is a difficult matter. Countries could agree on a checklist of points that governments may want to take into account in their incentives policy and practices. It could help to assess the costs and benefits of using incentives and provide operational criteria for assessing their effects (UNCTAD, 1995, pp 303-304).

Option 2(g): Encouraging development-oriented incentives

As noted above, certain types of incentives may be useful tools for the economic development of developing countries. Behavioural incentives in particular can fulfil this role, if they are part of a wider development policy. Accordingly, IIA provisions could seek to promote such “development friendly incentives”, through permissive clauses that

preserve the host country's discretion to offer such incentives. For instance, incentives for the transfer of technology and skills could be expressly encouraged, by making them "non-actionable", i.e. making them secure against legal action.

In addition, provisions could be included to extend to the activities of home countries. These can be divided into two types: first, provisions that limit the use of financial incentives on the part of host developed countries to attract FDI, so as to avoid unfair competition over internationally mobile investment to the detriment of developing host countries that may be unable to afford such incentives; second, provisions encouraging development friendly home country incentives.

The main development effect of such provisions, as explained in sections II and III above, is to act as a spur to investment in developing host countries. The latter, in particular, could be considered as part of the range of home country measures to encourage FDI flows to developing countries and increase the benefits from them (see further UNCTAD, 2003a, chapter VI). Such provisions would incorporate home country measures into IIA obligations. Such home country provisions could be hortatory in nature and could encourage "soft" cooperation in such areas as information exchange, assisted outreach to home country business groups and seminars and other educational activities geared to improving awareness of investment opportunities in host developing countries. On the other hand, binding obligations could also be included, though this may be a more difficult step. Such provisions could require financial commitments on the part of developed home country parties to IIAs through e.g. assistance programmes. In addition commitments could be linked to follow up programmes that seek to ensure the fulfilment of such commitments. Finally such provisions would need to take into account possible extraterritorial effects of home country measures and ensure that the obligations contained therein do not contradict but complement host country incentives measures. Thus a degree of cooperation between

countries party to an agreement containing home country incentives measures may be necessary.

* * *

The foregoing discussion has highlighted issues concerning the use of incentives to attract FDI and benefit more from it. A number of alternative approaches exist in this respect. There may be strong reasons, especially of a developmental nature, for adopting special treatment of foreign or domestic investors (as the case may be). Where such reasons are strong, it may be important to preserve the policy space of host countries in appropriate provisions in IIAs. On the other hand, such reasons must be balanced against possible distortions of market mechanisms that may ensue from governmental intervention in this area. Thus, the challenge for negotiators of IIAs, should they wish to include provisions on incentives in future agreements, is to find ways of enhancing market mechanisms while accepting that, in certain circumstances, the use of incentives may be justifiable. However, this issue remains highly sensitive and so the development of IIA provisions in this field is likely to be approached with considerable caution.

Notes

- ¹ This section draws on UNCTAD, 2003a, pp. 124-126.
- ² Central and Eastern European countries tend to use a mix of fiscal and financial incentives (Mah and Tamulaitis, 2000).
- ³ For example, when Intel decided to locate its sixth semiconductor assembly and test plant in Costa Rica, it did so after having evaluated sites not only in Latin America but also in China, India, Indonesia, Singapore and Thailand (Spar, 1998).
- ⁴ These gaps may arise from the general benefit of attracting TNCs to integrate the host economy more closely into global value chains, from specific technological and skill benefits of FDI, the stimulus to local competition or from launching a cumulative process of building industrial capabilities or agglomerations.
- ⁵ On the other hand, investments that are largely determined by incentives are more likely to leave as soon as the financial or fiscal benefits expire. In Botswana, for example, which offered generous investment incentives for the duration of five years for individual projects, many companies, both domestic and foreign, decided to close down their activities after the incentives had expired (UNCTAD, 2003c).
- ⁶ For example, economic development agencies in the United States have included claw back clauses in incentive agreements, stating that, if the company concerned did not maintain this many jobs or spend that much capital, then the development agencies had the right to ask for the money back. While this right has traditionally seldom been exercised, there are signs that things are changing. For example, in response to such claims, Alltel, a large telecom company, volunteered to repay \$11.5 million of the \$13 million it got from the state of Georgia two years ago to set up a call centre in the state (Oliver, 2003).

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