Towards an Asia-Pacific investment code*

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The Asia-Pacific Economic Cooperation organization has been considering developing and adopting a voluntary agreement to govern foreign direct investment in the region[1]. This article makes the case that such an agreement would be a positive step forward if, and only if, certain substantive standards are met. Desirable substantive provisions of an Asia-Pacific agreement are outlined and compared to those in existing agreements of the Organisation for Economic Co-operation and Development and the North American Free Trade Agreement, as well as the voluntary code already proposed by the Pacific Economic Cooperation Conference.

Introduction

Recommendation 3 by the Asia Pacific Economic Cooperation (APEC) Eminent Persons Group in its report to the 1993 APEC Ministerial Meeting was that "APEC should adopt an Asia Pacific Investment Code (APIC) to reduce the uncertainties and transactions costs of trade and investment in the region" (APEC, 1993, p. 38). At that meeting, the ministers agreed to make foreign-direct-investment (FDI) policy a priority for work by a newly created Trade and Investment Committee. This was amplified in the Vision Statement of an APEC heads of State meeting, wherein the heads of State "ask APEC to undertake work aimed at deepening and broadening the outcome of

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[1] The Asia-Pacific Economic Cooperation (APEC) organization was created in 1989 as a forum for regular discussions on regional trade issues and economic cooperation. Its membership comprises 17 economies : Australia, Brunei Darussalam, Canada, China, Hong Kong, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Singapore, Taiwan Province of China, Thailand and the United States. These economies (with the exception of Papua New Guinea and with the addition of Chile, Peru and Russia) also belong to the Pacific Economic Cooperation Council (PECC), a tripartite group comprising members from the private sector, academia and Government.

the Uruguay Round, strengthening trade and investment liberalization in the region . . ." (APEC, 1993b, p. 3). Part of this work, it was agreed, would include the development of a non-binding APIC, to be presented at the APEC ministerial meeting held in Jakarta in October 1994. The development of such a code was previously proposed by the Pacific Economic Cooperation Council, which submitted a model APIC for consideration by the APEC ministers.

This article, which is based on an issues paper prepared for the APEC Eminent Persons Group, examines the issues surrounding the creation of an APIC. The next section presents the case for moving ahead with the creation of an APIC. The following section discusses what substantive provisions an APIC might contain, along with a discussion of how the relevant issues addressed by these provisions are handled in existing investment instruments. The last section suggests that a successfully concluded APIC could be a model for a future investment agreement within the context of the nascent World Trade Organization.

Foreign direct investment in the Asia-Pacific region and the need for an Asia-Pacific investment code

During the 1990s, FDI has emerged as the largest and fastest growing component of external financing for a number of the rapidly growing APEC countries (World Bank, 1993).[2] During the second half of the 1980s, FDI flows expanded rapidly, but the vast bulk of these flows remained within the developed countries (Graham and Krugman, 1993). Some of these flows were intraregional within the APEC region, as in the case of FDI flows from Japan to the United States. The early 1990s, however, witnessed a significant drop in FDI flows among the developed countries (including Japanese FDI to the United States), but a rise in FDI flowing to (and among) developing countries, especially those within the APEC region.[3]

In fact, during the 1980s boom, most developing countries in the APEC region, especially those in East Asia and, to a lesser extent, Mexico, were host to rising FDI flows that have continued into the 1990s (World Bank, 1993 and table 1). Most FDI flows in 1992 went to China, where a

[2] It should be noted that most Asian nations do not seek FDI as a source of finance, but rather for other reasons, as discussed in this article.

[3] However, in 1992, intra-developed-country FDI flows still exceeded FDI flowing into the developing countries by about three to one. In 1986, this ratio was about five to one.

truly spectacular rise occurred in 1992 ($11 billion, even after accounting for possible "round tripping") (Lardy, 1994) and 1993 ($26 billion) (UNCTAD-DTCI, 1994).[4] This is widely believed to have resulted in part from a substantial liberalization of Chinese policies towards the treatment of FDI. Indeed, it can be argued that China now has one of the most liberal policies in the whole East-Asian region.

Table 1. Foreign-direct-investment inflows into the Asia Pacific Economic Cooperation economies, 1989-1992

(Millions of dollars)

Economy	1989	1990	1991	1992
Brunei Darussalam	..	−1	−1	−4
Canada	2 626	7 638	6 592	7 757
China	3 393	3 487	4 366	11 156
Indonesia	682	1 093	1 482	1 774
Japan	−1 060	1 760	1 370	2 720
Korea, Republic of	758	715	1 116	550
Malaysia	1 668	2 333	4 073	4 118
Mexico	3 037	2 632	4 762	5 366
Philippines	563	530	544	228
Singapore	2 773	5 263	4 395	5 635
Thailand	1 776	2 444	2 014	2 116
United States	67 870	45 140	23 970	2 370

Source: UNCTAD-DTCI, 1994 and International Monetary Fund, 1993.

A number of APEC nations, in addition to China, have recently substantially liberalized their investment policies. Some of the most far-reaching liberalization has in fact occurred in some nations that have historically discouraged FDI in their economies. For example, Mexico, in implementing its North American Free Trade Agreement (NAFTA) obligations, adopted some of the most extensively liberalized policies yet announced (Hufbauer and Schott, 1993). In terms of FDI inflows, these reforms have apparently paid off handsomely. In mid-1993, the Republic of Korea—historically one of the

[4] Because foreign investors in China now can receive treatment that is substantially better than that accorded domestic investors, some domestic Chinese investors channel their investment through foreign intermediaries (usually located in Hong Kong) in order to qualify for the treatment accorded to foreign investment. Exactly how much of the total recorded FDI into China is the result of such "round tripping" is not known, but large amounts of outward investment flowing (both ways) between China and Hong Kong offer indirect evidence that it is substantial.

most restrictive countries towards FDI in the APEC region—announced a major liberalization of its policies in the hope of attracting more FDI; however, it is still too early to evaluate the effects of this move (Graham, 1994). Motivated in part by the fear that increased FDI into China could lead to reduced FDI elsewhere in Asia, a number of other Asian countries in the APEC region were considering further liberalization in 1994.

Indeed, throughout the APEC region, liberalization has come about as a result of both a growing recognition that FDI brings benefits to recipient countries that go well beyond those associated with the financing of international obligations (UN-TCMD, 1992) and a desire not to be left behind as other countries (particularly China) liberalize their policies. Foreign direct investment is, of course, the manifestation of the international spread of operations of individual business firms which, once their operations become internationalized, are termed transnational corporations (TNCs). Benefits to host countries include inward transfer of technology and management know-how, both of which tend to permeate the general economy. Transnational corporations also have in place international networks that facilitate the marketing of exports of host countries in which these firms operate. Thus, many countries have come to see the liberalization of FDI policy as being consistent with—and perhaps necessary for—export promotion. The trade generated by TNC networks is characteristically two-way, and these networks generate exports for home as well as host countries. The benefits are also two-way: empirical evidence suggests that both groups of countries benefit.[5]

One characteristic of FDI in the APEC region is that much of it is intra-regional (Wells, 1993). The largest investor in the region is Japan, which emerged as a large net foreign direct investor in Europe and North America, as well as East Asia, during the 1980s (table 2).

Since 1989, Japan's total outward FDI flows have declined, but a growing percentage has been invested into other East Asian nations. The second largest investor in the region is the United States (table 2). The Republic of Korea is also a major intra-regional investor. Outflows of FDI from the Republic of Korea were in excess of $1 billion in each of 1991 and 1992, and most of its outward stock of FDI is located in other Asian countries. Hong Kong, Singapore and Taiwan Province of China (and, increasingly, China) also have significant amounts of FDI in other Asian countries. The

[5] The evidence is surveyed by John H. Dunning (1993). See especially chapters 10-18 for evidence regarding the impact of FDI on both home and host nations.

Table 2. Foreign-direct-investment flows and stock from Japan and the United States into the APEC economies, 1987-1992

(Millions of dollars)

Flows of FDI from Japan to:[a]	1987	1988	1989	1990	1991	1992	Stock, 1992
China	1 226	296	438	349	579	1 070	4 472
Hong Kong	1 072	1 662	1 898	1 785	925	735	11 510
Indonesia	545	586	631	1 105	1 193	1 676	14 409
Korea, Republic of	647	483	606	284	260	225	4 623
Malaysia	163	387	673	725	880	704	4 815
Philippines	72	134	202	258	203	160	1 943
Singapore	494	747	1 902	840	613	670	7 838
Taiwan Province of China	367	372	494	446	405	292	3 427
Thailand	250	859	1 276	1 154	807	657	5 886
Subtotal, East Asia	4 868	5 569	8 238	7 054	5 936	6 425	54 300
ASEAN[b], excluding Brunei Darussalam	1 524	2 713	4 684	4 082	3 696	3 867	34 891
Australia	1 222	2 413	4 256	3 669	2 550	2 450	21 063
Canada	653	626	1 362	1 064	797	753	7 207
Mexico	28	87	36	168	193	60	2 127
New Zealand	121	117	101	231	236	67	1 228
United States	14 704	21 701	32 540	26 128	18 026	13 819	162 373
Total	21 596	30 513	46 533	38 314	27 738	6 425	54 300

Flows of FDI from the United States to:	1987	1988	1989	1990	1991	1992	Stock, 1992
China	..	..	100	32	54	44	469
Hong Kong	381	708	465	265	420	1 856	8 544
Indonesia	–288	–251	–65	659	608	656	4 278
Korea, Republic of	215	237	332	312	194	–140	2 779
Malaysia	20	156	50	222	185	55	1 714
Philippines	–89	90	49	177	–27	–17	1 565
Singapore	275	–16	165	481	1 127	1 097	6 631

Table 2 *(continued)*

Flows of FDI from the United States to:	1987	1988	1989	1990	1991	1992	[illegible]
Taiwan Province of China	432	203	177	209	429	154	2 870
Thailand	194	–149	384	315	242	367	2 459
ASEAN[b], excluding Brunei Darussalam	112	–170	583	1 854	2 135	2 158	16 647
Subtotal, East Asia excluding Japan	1 140	978	1 657	2 672	3 232	4 072	31 309
Australia	1 062	799	1 997	678	1 071	1 335	16 697
Canada	7 450	2 641	1 268	3 471	1 164	3 257	68 432
Japan	2 908	1 313	299	844	244	867	26 213
Mexico	275	608	1 652	1 868	2 305	1 261	13 330
New Zealand	121	91	162	1 962	–243	138	3 008
Total	12 956	6 430	7 035	11 495	7 773	10 930	158 989

Source: Japan, Ministry of Finance, 1993; United States, Department of Commerce, 1993.

[a] Figures are on notification basis for fiscal years ending March 31.

[b] The Association of South East Asian Nations (ASEAN) comprises Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand.

outward FDI flows of these countries, in turn, reflect the growth of TNCs based in these countries.

The increasing diversification of sources of FDI within the APEC region has been a positive factor contributing to policy liberalization. Diversification reduces the possibility that FDI will enable a large country, or firms based in that country, to dominate other countries economically. Such fears were widespread during the 1970s and early 1980s, but have receded in recent years.

On the other side of the Pacific, all three APEC countries located at the eastern rim (United States, Mexico and Canada) play a major role as investors in the region and, indeed, have recently concluded an important regional trade and investment agreement, NAFTA, with pioneering provisions regarding FDI. The United States, long the world's largest source of FDI, also became the largest recipient of such investment during the 1980s. Beginning in late 1991, new FDI flows to the United States fell sharply, but United States FDI abroad continued to increase. East Asia and Mexico have accounted for growing shares of FDI flows from the United States in recent years; in East Asia, the United States is the second largest source of FDI after Japan, and in Mexico, the United States is by far the largest source country (table 2). However, in spite of significant increases in United States FDI flows to these countries during the past three years, the total stock of United States FDI in the APEC region is far less than in Europe. Furthermore, the stock of United States FDI in East Asia is much lower than that of Japan and has been growing more slowly in recent years.

As previously suggested, the sharp increase of FDI in Mexico is linked to internal policy reforms and to the establishment of NAFTA. The North American Free Trade Agreement itself contains very detailed, indeed path-breaking, provisions pertaining to FDI largely in the direction of investment liberalization (Graham and Wilkie, 1994). In addition to having been prepared to implement these liberalization provisions even if NAFTA had failed, Mexico has announced that it will extend its own plan for investment liberalization—which is largely written into Mexican law and conforms to NAFTA obligations—to all direct investors in Mexico on a most-favoured-nation basis.[6] This multilateralization of the most-favoured-nation clause on the part of Mexico is consistent with the idea of open regionalism, which is

[6] Specifically, Mexico has extended its NAFTA chapter 11 part A obligations on a most-favoured-nation basis.

more often associated with the thinking of Asian trade and investment experts than with Latin American policy makers.

Canada is both an important home and host for FDI in the APEC region. Most of Canada's outward FDI is located in the United States, but Canada's FDI in Mexico has grown from almost nothing to a significant amount during the past two years. Canada is the second largest host to FDI among the APEC countries, but most of FDI in Canada is either from the United States or Europe. Canada has sought to attract FDI from Japan and other Asian countries, but with limited success to date.

In the context of all these developments, an APIC—which would be voluntarily adopted by the APEC—would be designed to facilitate investment in the region by means of a series of commitments by Governments to make the policy environment in their countries even more friendly to foreign investors. Such a code would be voluntary in the sense that APEC countries would choose whether or not to adopt it. But a country that has signed on to the code should accept its obligations as binding, subject to exceptions (see the following section). Such an approach is desirable for the following reasons:

- A code would help to lock into place the policy liberalization that has already taken place. This would reassure potential investors that their investments would not be at risk due to future policy shifts in a de-liberalizing direction. Although FDI is currently booming in the APEC region, there remain some potential investors that are currently reluctant to invest in some of its member countries, for fear of future restrictions or de-liberalization.

- An APIC would establish a set of uniform basic standards for the treatment of FDI throughout the region.[7] Uniform standards for treatment of FDI would, *inter alia*, reduce ''policy shopping'' by investors, that is, the playing of one Government against another to receive investment incentives more satisfactory for the firm (but possibly less satisfactory for the country) than could be achieved in the absence of uniform standards.

- An effective APIC would create a mechanism whereby disputes between investor firms and countries (or among countries over investment-related matters) could be resolved effectively. No such mechanism exists in the General Agreement on Tariffs and Trade

[7] However, as elaborated in the next section, those countries choosing to adopt an APIC could deviate from its standards if they did so transparently.

(GATT) (or will exist in the World Trade Organization), because the existing dispute-settlement mechanisms do not cover investment issues except for a very narrow subset affected by the new agreement on trade-related investment measures (discussed in the following section). The North American Free Trade Agreement has created a mechanism that is better than any other currently in existence but, as discussed in the next section, it could be improved upon. The existence of such a mechanism would facilitate FDI because the risk of disputes being resolved unilaterally and possibly unfairly by national Governments is reduced. An effective dispute-settlement mechanism would also reduce the likelihood of disputes over FDI issues emerging among the APEC countries, as well as between firms and Governments in the region.

The elements of an Asia-Pacific Investment Code

An effective investment code would contain five central elements, of which three are statements of basic obligations of countries to investors, one is an institutional arrangement, and one is a set of additional obligations of countries and of investors.[8] The three basic national obligations would be: transparency, right of establishment and national treatment. The institutional arrangement concerns the dispute-settlement mechanism. The additional obligations would be designed primarily to ensure that actions taken by any APEC country, or a TNC operating in that country, do not unduly harm the interests of other APEC members.

Transparency

This provision implies that all laws, regulations and rules pertaining to FDI or the operations of TNCs be explicit and accessible by interested parties (e.g., published in national registers or national legal codes). It also implies that these laws, regulations and rules be administered in an open and non-arbitrary fashion.[9] There can be legitimate exceptions to transparency, for example in cases where vital national security issues are at stake, or

[8] All five elements are contained in NAFTA.

[9] This might imply that significant additions or amendments to laws or regulations be published in advance and that the affected public be given a chance to comment upon the additions or amendments before they come into effect.

where the administration of laws, regulations and rules requires that officials have access to confidential business information. However, the general presumption of any code would be that laws, rules, regulations and procedures be transparent. In particular, any exceptions to the principles of right of establishment or national treatment should be transparent.

Right of establishment

This principle provides that, subject to transparent exceptions, a foreign investor should have rights of establishment no less favourable than those granted to domestic investors, for example, with respect to the establishment of a greenfield operation or the acquisition or merger of an existing business.[10] Under this obligation, countries could, if they so choose, offer rights of establishment to foreign investors that are more favourable than those offered to domestic investors.

It should be noted that the right of establishment, thus defined, does *not* require that State-owned monopolies be opened to foreign investors or that entry restrictions, more generally defined, be lifted for these investors. Rather, it implies that such restrictions apply *equally* to private domestic and foreign investors.[11] Likewise, the right of establishment does not preclude Governments from scrutinizing mergers and acquisitions. Rather, it implies that the review of these transactions be conducted under the same rules, irrespective of whether or not the parties to the transaction are foreign-owned.

The right of establishment also encompasses certain other rights accorded to foreign investors by host Governments, for example, the right to make monetary transfers (subject to any constraints that might be imposed by laws governing bankruptcy, solvency and rights of creditors, as well as criminal law) and the right to appoint the directors and senior officers of the foreign affiliates.

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[10] The North American Free Trade Agreement, in addition to these traditional forms of investment, extends its investment obligations to non-traditional forms of investment (e.g., non-equity forms, such as affiliates that are locally owned, but managed by foreign entities under long-term service contracts).

[11] For this reason, in NAFTA, the right of establishment is part of the national treatment obligation. However, in other contexts (most specifically, the Organisation for Economic Co-operation and Development (OECD)) national treatment applies to investments *after* they are established.

In practice, APEC countries do not grant unconditional rights of establishment to foreign investors. For example, all APEC countries impose industry-specific restrictions, while some retain the right to screen FDI on the basis of economic or other criteria. The latter include Canada and Mexico, which can screen incoming FDI even within the context of NAFTA obligations, that is, they can use these obligations with respect to investments from other NAFTA countries. The United States retains the Exon-Florio authority (even under NAFTA obligations) to block acquisitions, takeovers or mergers between domestic and foreign firms if these threaten to impair national security. All three NAFTA countries maintain certain industry-specific exceptions to an unconditional right of establishment.

Thus, the right of establishment and transparency exceptions are intimately related principles. Exceptions to the right of establishment—whether these are industry-specific restrictions or general rights of a Government to impose measures affecting specifically the rights of foreign investors (as opposed to all investors) to establish business activities—are acceptable, but must be explicit and public knowledge.

The right of establishment is dealt with in a number of existing and proposed international instruments. The North American Free Trade Agreement, for example, contains lengthy appendices listing exceptions to the right of establishment. These are part of the national treatment exceptions (discussed below).

The right of establishment is also dealt with in OECD. The member countries of OECD have subscribed to two codes, the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations, under which each country pledges to remove barriers to inward and outward FDI; to allow the free transfer of capital following the liquidation of assets or the obtaining of finance in the form of long-term loans; and to allow current transactions (payments of dividends, interest payments, royalties, etc.). In principle, these codes are binding for all OECD members. An OECD member must categorize any exceptions to its obligations under the two codes as *reservations* or *derogations*, the former being long-term exceptions and the latter being temporary ones. The two codes also bind each member to a *standstill* on new reservations and derogations, that is, an obligation not to enlarge its list of exceptions.[12]

[12] The codes also commit each member to "roll back" its exceptions over time, that is, to reduce these in number or scope. However, in recent years, there has been very little such reduction de facto.

Under OECD procedures, the practices of each member are regularly reviewed to determine if these obligations are being met. This review is conducted by the standing OECD Committee on Capital Movements and Invisible Transactions. During the review, in principle, any member can demand that the country under review, or any other country, explains and justifies any new measure that could be seen as being in violation of code obligations although, in recent years, countries have exhibited a reluctance to exercise the right to make such a demand.

The right of establishment is dealt with in the Pacific Economic Cooperation Council draft of an APIC under the following language: "signatories will facilitate foreign investment in all commercial fields and activities other than those explicitly specified: activities where foreign investment is restricted or excluded will be explicitly specified by each signatory and the list of restrictions will be made available to all interested parties" (PECC, 1993, pp. 13-14). The provision is not wholly satisfactory as currently drafted because the word "facilitate" seems to imply something less than an unconditional right of establishment subject to transparent reservations. An earlier draft used the word "permit" rather than "facilitate", but at the 1993 Pacific Economic Cooperation Council Trade Policy Forum the wording was changed. Also, it would be desirable that reservations and exceptions be listed prior to a country adopting an investment code. The draft code, as proposed by the Pacific Economic Cooperation Council, taken literally, would allow countries to list these after adopting the code (". . . will be explicitly specified . . .").

National treatment

This provision is akin to the right of establishment: while the latter pertains to entry by foreign investors, the former pertains to ongoing operations. The basic principle of national treatment is that foreign investors receive (under law, rules, regulations and administrative procedures) substantive treatment no less favourable than that accorded to domestic investors. As already noted, NAFTA treats the right of establishment as part of the national treatment provision. The logic is that some Government measures apply to a business in the process of being established and to established enterprises alike, and that these measures should be treated consistently in an investment code. This notwithstanding, the tradition has been to consider the right of establishment and national treatment to be separate matters.

In practice, no country currently grants full unconditional national treatment to foreign investors. Thus, again, a critical adjunct to national treatment is that exceptions to national treatment be transparent.

In NAFTA, FDI provisions are contained in chapter 11.[13] The key sentence in the text of the national-treatment clause of NAFTA reads: "Each Party shall accord to investors of another Party treatment no less favorable than it accords, in like circumstances, to its own investors . . ." (article 1102.1). ("Party" in this context means a national Government of a NAFTA member country.) This language, it would seem, does not preclude foreign investors from receiving preferential treatment over national investors. The North American Free Trade Agreement also provides for most-favoured-nation treatment, whereby if any NAFTA Government grants to the investor of any country treatment that is better than national treatment, it must grant that same treatment to investors from NAFTA members.

Integral to the national-treatment clause of NAFTA is a lengthy set of exceptions to national treatment contained in the annexes to the agreement. In accordance with the principle of transparency, the exceptions (reservations) in the annexes are the only allowable ones to national treatment.[14] (All of these exceptions appear in annexes I through VII of the text of the agreement and total several hundred pages.) Unlike OECD, NAFTA contains no provision for a periodic review of exceptions to the right of establishment, nor is there any presumption that these will be liberalized over time. However, Mexico—whose lists greatly exceed those of either Canada or the United States—has unilaterally committed itself to phasing out some of its reservations as part of its overall effort to liberalize its FDI policies.[15]

[13] However, certain industries (most notably financial services) are treated under separate articles from FDI in general. Where this happens, the industry-specific articles (and exceptions) override those of the chapter.

[14] However, again, exceptions under industry-specific chapters also apply and override any Chapter 11 provisions. Exceptions to NAFTA obligations are an example of what is termed in trade policy circles a "negative list": the only exceptions allowed are those that appear in the list (in the case of NAFTA, these include lists attached to industry-specific chapters, as well as the annexes to Chapter 11). An alternative approach is a "positive list", under which government obligations apply only to activities appearing on the list; an example of that approach is the General Agreement on Trade in Services negotiated under the Uruguay Round. Most specialists agree that a negative-list approach is better (in the sense that it is more liberal) than a positive-list approach, because the latter often allows for non-transparent exceptions.

[15] Also, Mexico retains its right to exclude foreign participation in activities and industries reserved for the State by the Mexican Constitution. However, if Mexico does allow foreign participation in any of these industries (as, indeed, it does) then that activity is subject to all Chapter 11 obligations; furthermore, Mexico cannot place any new restrictions on these activities.

The national treatment obligations of NAFTA are binding upon State, provincial and local Governments. However, restrictions on foreign investors imposed by such subnational governmental entities are to be "grandfathered". To "grandfather" means that existing exceptions can remain in force, but that no new ones can be implemented after NAFTA comes into force. State and provincial Governments must notify all such exceptions within two years of NAFTA coming into force. Local (municipal) Governments, by contrast, do not have to list their exceptions, but must be prepared to show that any exception that is enforced was in place prior to NAFTA coming into force.

In addition to the OECD codes discussed above, which do not provide for full national treatment for foreign-controlled enterprises in member countries, OECD has adopted a non-binding *national treatment instrument.* Those members choosing to adhere to that instrument (all currently do) must grant national treatment to enterprises that are controlled by investors from another member country subject to reservations and derogations. A number of efforts have been mounted over the years to make the national treatment instrument binding and to make OECD countries subject to reviews similar to those conducted under the codes, but these have foundered over specifics. The Committee on International Investment and Multinational Enterprises of OECD is the organ that debates how to strengthen the national treatment instrument.

Overall, then, the national-treatment provisions of NAFTA and OECD are flawed. One opportunity for APIC is to contain better national-treatment provisions than those currently in existence. The Pacific Economic Cooperation Council proposal for an APIC goes part way in this direction by specifying that "foreign investors will receive treatment for that investment no less favorable than accorded by the host Government to its own investors"; that "exceptions to national treatment will be explicitly specified by each signatory"; that "signatories will introduce no new legislation or regulation which extends the list of exceptions to national treatment", and that "signatories agree to review regularly this list with a view to the reduction of the exceptions" (PECC, 1993, pp. 15-17). These last two provisions are often termed *standstill* and *rollback.* In principle, all these provisions head in the right direction. What is lacking is the means to enforce the commitment. For example, there is no established mechanism to create a rollback other than a vague agreement to review the exceptions, nor even an effective dispute-settlement mechanism via which breaches of the obligation can be

challenged. Again, it would be desirable that all reservations and exceptions to national treatment be specified before a code goes into effect.

Dispute settlement

An effective dispute-settlement mechanism would be at the heart of any investment code. It is also the investment issue on which countries are the most reluctant to act, given its implications for national sovereignty (specifically, the issue of whether or not national authorities would be bound by the outcome of a dispute-settlement mechanism). For example, in the Pacific Economic Cooperation Council draft code, the section labeled "dispute resolution" sets up no new procedures, but rather encourages signatories "to reduce the likelihood of disputes . . . by simplifying, where appropriate, legislation and regulations . . ." and to "consider becoming parties to international legal conventions". Where disputes actually arise, the Pacific Economic Cooperation Council draft goes no further than to indicate that "signatories will encourage parties, including relevant public agencies or authorities, to consult in good faith . . ." and "signatories undertake to facilitate access to domestic courts . . ." (PECC, 1993, p. 18).

Currently two international fora exist that are meant to serve for the resolution of investment disputes: the International Centre for Settlement of Investment Disputes (ICSID), a body within the World Bank, and the United Nations Commission on International Trade Law (UNCITRAL). Both of these institutions suffer from common flaws, notably that neither facility can undertake to settle any investment dispute unless both the disputing firm and the Government against which the dispute is lodged agree to use the facility; and if agreement is achieved, neither institution can enforce a settlement once a decision has been reached. Also, the procedures of both facilities have been criticized for being excessively legalistic and biased in favour of countries.

The recently concluded Uruguay Round has brought into existence a reformed dispute-settlements procedure in GATT under which a dispute-settlement body will be created. That body will have the authority to establish panels, adopt panel and appellate reports, maintain surveillance of the implementation of rulings and findings and authorize the suspension of concessions and other obligations under the covered agreements. The workings of the dispute-settlement body are set out in a lengthy document, but the essence is that body will determine, subject to complaints by GATT members, whether a particular member country has breached GATT rules. If there is

such an infringement, it is to be assumed under the new rules that this will cause nullification or impairment of benefits to the complaining party and that this party then (under most circumstances) would have the right to sanction the infringing party by withdrawing concessions or other obligations accorded to that party. Before this can happen, an effort must be made to resolve the dispute through consultation and negotiation. Sanctions must be commensurate with the damage caused by the nullification or impairment. Parties to a dispute can agree to binding arbitration.

There are two critical weaknesses of the dispute-settlement body mechanism as a means of resolving investment disputes. First, GATT's substantive provisions—even after the completion of the Uruguay Round—do not comprehensively deal with investment issues (except for a narrow subset of these under the agreement on trade-related investment measures, discussed below), and the dispute-settlement body mechanism can only be invoked to deal with infringements of GATT obligations. Second, the only parties that have standing in the dispute-settlement body mechanism are Governments; but investment disputes are often not between Governments, but between a Government and a firm.

The settlement mechanism of NAFTA for FDI disputes is tailored to deal with investment disputes *per se* (and it is certainly stronger than the Pacific Economic Cooperation Council draft code provisions), but still stops far short of granting full supranational authority over sovereign actions. The main purpose of the mechanism is to provide some assurance that NAFTA members will actually abide by their obligations. Such assurance was widely sought by firms operating within NAFTA, especially with respect to Mexico, and the de facto abandonment of the *Calvo doctrine* by Mexico in favour of the NAFTA mechanism is one major reason for renewed enthusiasm of TNCs for Mexico. The incorporation of a dispute-settlement mechanism into an APIC that is at least as strong as that of NAFTA should be actively considered.

One desirable feature of the NAFTA mechanism is that, unlike dispute-settlement body procedures, it enables an investor of a NAFTA party to seek arbitration against another party where that party allegedly fails to meet obligations set out under part A of NAFTA's Chapter 11 (pertaining to investment), or articles of chapter 15 pertaining to State enterprises or State-sanctioned monopolies, and where the investor can demonstrate monetary loss resulting from this failure. Only an investor, as opposed to an investment, can seek arbitration. This implies that the parent firm can seek arbitration of a dispute with a host country (provided that both the home and host

countries are NAFTA members), but an affiliate cannot. However, the parent firm can seek arbitration on behalf of the affiliate.[16] It should be noted that, whereas both parties to a dispute must agree to arbitration (if arbitration is sought) under other dispute-settlement body procedures, one party (the investor) can unilaterally bring a dispute to arbitration under NAFTA.

Under NAFTA procedures, as under dispute-settlement body procedures, the effort must be made to resolve a dispute by means of consultation and negotiation before arbitration can be sought. If arbitration is sought, the arbitration is carried out under the rules of the World Bank or the United Nations at the option of the disputing investor (Graham and Wilkie, 1994). Specifically, the disputing investor may submit a claim to arbitration under the rules of ICSID within the World Bank, the additional facility rules of ICSID, or the UNCITRAL arbitration rules. The ICSID rules require, *inter alia*, that a judgement by an arbitration tribunal be treated as though it emanated from the highest court in the relevant country.[17] In any of these three cases, NAFTA modifies somewhat the arbitration procedures, the most important of these being that, under NAFTA, the Government against which the dispute is lodged *must* be willing to submit the dispute to arbitration if the investor seeks it. Under any of these rules, a tribunal is established that can order interim measures to protect the rights of the investor and, if a breach of NAFTA is found, can order that an award be made to the investor, including monetary (but not punitive) damages. The damages are awarded under the New York Convention on Recognition and Enforcement of Arbitral Rewards, whereby, in the event of nonpayment of the damages, the investor could pursue assets of the Government of the member country of NAFTA against which the award was made. The tribunal, however, cannot order that the offending party take measures to modify its policies and practices so as to meet its NAFTA obligations.

The use of the arbitration provisions of NAFTA's Chapter 11 does not preclude a disputing investor (or its investment) from seeking redress of the same dispute in the national or local judicial system of the party allegedly breaching a NAFTA obligation, if the party is Canada or the United States. Mexico requires that, if a dispute is brought to arbitration, proceedings involving the same dispute cannot be simultaneously brought before a Mexican court. The Chapter 11 dispute-settlement mechanism cannot be used to

[16] This distinction could be of importance if, for example, the dispute were to be initiated by minority shareholders of a foreign affiliate.

[17] At the time of the conclusion of NAFTA negotiations, neither Canada nor Mexico subscribed to ICSID. Both countries, however, plan to do so in the future.

contest an adverse ruling on entry or establishment by the National Commission on Foreign Investment in the case of Mexico, or under the Investment Canada Act in the case of Canada. Also, this mechanism cannot be used to contest the blocking of an acquisition, takeover or merger by the President of the United States under the Exon-Florio authority.

There are weaknesses in the NAFTA approach to dispute settlement that could be redressed in an APIC. Chief among these is that the procedures provide some deterrent against a signatory nation breaching its obligations, but there is no power created by NAFTA to force compliance.[18] Such powers can be found, for example, in the European Union, where the European Court of Justice can order that member countries cease and desist from practices that violate the Treaty of Rome.[19] It is doubtful that the APEC countries would agree to the European approach, but stronger deterrents to the breaching of obligations could be explored.

Another weakness of NAFTA is also intrinsic to the ICSID and UNCITRAL procedures, namely, the highly legalistic and, in some areas, substantively deficient dispute-settlement mechanism. Probably the most important deficiency is the failure of any of these sets of rules to establish time limits on actual arbitration.[20]

In sum, an effective investment-dispute mechanism would be an essential feature of a meaningful APIC. The Pacific Economic Cooperation Council dispute-settlement clause would not be effective. Likewise, ICSID and UNCITRAL are not effective facilities for dispute settlement, and the new GATT procedures cover only a few investment issues. The dispute-settlement mechanism of NAFTA is a step forward, but it is still very limited. Thus, in this area, APEC has an opportunity to break new ground.

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[18] However, it remains a possibility that the deterrence created by NAFTA's Chapter 11 arbitration procedures will de facto cause countries not to violate obligations. For example, if arbitration is sought, the offending party might choose to revise its policies and procedures rather than risk an adverse finding by an arbitration tribunal set up under Chapter 11, part B. Furthermore, an adverse finding against a NAFTA-member Government by such a tribunal (that is, an awarding of damages by such a tribunal) could become the basis for Government-to-Government dispute proceedings under Chapter 20 provisions. If, as the result of Chapter 20 provisions, a NAFTA-member Government were to be found in violation of Chapter 11, part A, obligations, other NAFTA members could impose sanctions on the offending country until the violations were redressed.

[19] At present, however, this power cannot be applied to most investment policies in Europe. It does reach policies affecting intra-European trade, including some investment-related policies such as State aids to industry having effects on trade.

[20] However, NAFTA does establish time and procedural requirements on investors and Governments with respect to the initiation of arbitration and response to the outcome of arbitration. It is only the arbitration itself that is not bound by time limits.

Additional obligations

As noted in the opening paragraph to this section, an APIC should contain additional obligations of signatory nations designed to ensure that actions taken by these nations, or by investors from or within these nations, do not unduly harm the interests of other APEC members or of investors in the region. Four areas that should be covered in this regard are expropriation, taxation, investment incentives and performance requirements.

- With respect to expropriation, international standards have been agreed upon in a number of existing or proposed instruments that should also appear in an APIC (e.g., NAFTA's FDI-related provisions, the World Bank's Investment Guidelines and the Pacific Economic Cooperation Council draft code are all pretty much consistent in respect to these standards). These standards do not prohibit an expropriation, but mandate that, if an investment is expropriated or nationalized, it must be for a public purpose; on a non-discriminatory basis (e.g., if it is decided that, for a public purpose, all activities in a certain industry are to be nationalized, this must apply equally to domestically owned and foreign-owned activities); in accordance with due process of law; and investors must be compensated for the full fair market value of assets that are forfeited without delay and in a fully convertible currency.
- In the domain of taxation, the main objective of an international agreement should be to ensure that the tax laws and policies of an APEC country with respect to FDI do not distort investment and other actions by TNCs in ways that affect adversely other APEC countries.[21] Specific measures that might be considered include: the simultaneous creation of uniform rules for transfer pricing and procedures for information sharing and dispute settlement among tax authorities to ensure that national authorities, as well as TNCs themselves, comply with the rules;[22] harmonization of laws and

[21] A series of proposals are developed in great detail in Hufbauer and van Rooij (1992). While these proposals are mostly directed to United States policy, many of them (for example, that countries adopt a territorial approach rather than a worldwide one to taxation of income with foreign tax credits) could be considered for international adoption.

[22] These would be desirable for investors because national Governments are always suspicious that TNCs might use transfer pricing to avoid local taxation. If all Governments were to work on the assumption that "internal" prices are manipulated and thus require forms to "gross up" local earnings to compensate for such manipulation, the result would be that some part of a firm's earnings would almost surely be double-taxed. Thus, TNCs should be eager to adopt a system whereby Governments can share information and take action against transfer-pricing abuse. Likewise, Governments should also be eager to adopt such a system.

regulations affecting the tax treatment of TNC income, including rules regarding the allocation of headquarters' expenses (e.g., research-and-development costs); harmonization of accounting standards; and the creation of rules regarding the granting of tax holidays.

- Investment incentives appear to have little impact on the aggregate volume of FDI flows worldwide, but can have an impact on specific location decisions within a region (Dunning, 1993). One consequence is that, if a national or subnational authority grants incentives (which can include direct and indirect subsidies to TNCs, including tax holidays, the provision of infrastructure specific to an investment undertaking and other measures), other national or subnational authorities often feel compelled to grant countervailing incentives to keep desirable investments from gravitating to the country or province originally granting the incentives. The overall result is that public authorities often bid against each other for FDI projects, which does not increase the total volume of such projects, but only serves the purpose of reallocating them. A consequence is a net transfer from the public treasury to the foreign investor without any corresponding gain to the public. Thus, investment incentives are "negative sum" in their overall effect on national or subnational Governments that are hosts to TNCs.

  The best approach for countries to take collectively with respect to FDI incentives would be to ban many categories of incentives altogether on the grounds that, on balance, no country benefits and, indeed, every country loses. For other categories, harmonized rules should be developed with respect to types and levels of incentives that national and subnational entities can offer. A number of questions would need addressing, for example, whether or not tax holidays should be abolished;[23] whether or not there should be limits on direct subsidies; and whether or not the provision of infrastructure creates external benefits such that it should be treated differently in terms of investment incentives.

  Two additional aspects of investment incentives might be noted:

[23] It should be noted that the value of tax holidays to foreign investors increases if the home country taxes TNC income on a territorial, rather than worldwide, basis. Hence, if agreements were ever to be reached for all countries to tax on a territorial basis, pressures upon individual countries to grant tax holidays would increase.

- First, if Governments—national or subnational—become involved in bidding against each other in order to attract FDI, and if each country has an equal desire for such investment, the richest Government will "win" the contest by virtue of having the "deepest pockets". Alternatively, if more affluent Governments participate in such a bidding process against less affluent ones, the latter will pay a higher price to the investor than they would have in the absence of the bidding, even if they do win the project. Either way, investment incentives tend to work to the disadvantage of poorer countries in relation to the richer ones.

- Secondly, no international agreement to date (including NAFTA) has addressed the issue of investment incentives. The Uruguay Round subsidies agreement deals with parallel issues (subsidies affecting trade), but not investment subsidies directly. The environmental provision of NAFTA bars abatement of environmental regulations as a means of inducing investment, but otherwise NAFTA does not deal with investment incentives. The Asia-Pacific Economic Cooperation organization, therefore, has an opportunity to play a pioneering role in this domain that will potentially benefit the poorer countries of the region.

Performance requirements on TNCs can have the same sorts of distorting effects on international commerce as trade restrictions. In recognition of this fact, new rules regulating some types of performance requirements have been incorporated into the Uruguay Round agreement on trade-related investment measures. It states: "Without prejudice to other rights and obligations under the General Agreement on Tariffs and Trade 1994, no Member shall apply any TRIM that is inconsistent with the provisions of Article III or Article XI of the General Agreement on Tariffs and Trade 1994" (General Agreement on Tariffs and Trade, section I, article 2, p. 1). The illustrative list of trade-related investment measures that fall into these categories includes domestic-content requirements, trade-balancing requirements and restrictions on imports of products used in, or related to, the local production of a foreign-owned enterprise. The new agreement applies only to goods and not to trade in services. The agreement requires the members of GATT to notify the Council for Trade in Goods within 90 days of the entry into force of the Agreement Establishing the World Trade Organization of all trade-related investment measures that are not in conformity with the agreement. The agreement calls for nonconforming trade-related investment measures to be phased out within two years for developed countries, five years for devel-

oping countries and seven years for the least developed countries. Some exceptions are allowed; in particular, developing countries can claim balance-of-payments exceptions. The trade-related investment measures agreement covers some (but not all) types of performance requirements. The North American Free Trade Agreement covers the GATT categories, as well as additional categories, including measures that would accord any sort of preference to the use of goods or services provided in the territory of a country; that would require in some way that the volume or value of imports associated with FDI be linked to the volume or value of exports generated by that investment; that would restrict the sale of goods or services by linking these to the value or volume of exports; that would require that technology or other proprietary knowledge be transferred to a non-related party, except where such a transfer is sought to remedy a violation of competition laws; or that would require that foreign investors serve as exclusive suppliers to a "specific region or world market". Like the trade-related investment measures agreement, NAFTA provides a transition period for the phasing out of existing performance requirements that are inconsistent with NAFTA obligations. Some specific performance requirements are "grandfathered" (i.e., allowed to continue). Both GATT and NAFTA prohibit the use of those performance requirements specified in the agreements as conditions for receipt of an advantage. Hence, the performance requirements covered by these two agreements cannot be used either as conditions for entry or as conditions for receipt of investment incentives. The North American Free Trade Agreement, however, explicitly permits the following performance requirements as conditions for receipt or continuation of an advantage: a specific location of production; the provision of a specified service; the training of local workers; the construction or expansion of particular facilities; and the carrying out of research and development in the territory of the Government granting the advantage. The regulations of NAFTA on performance requirements, it should be noted, are binding upon subnational entities, as well as national Governments.

The Pacific Economic Cooperation Council draft for a code contains a provision on performance requirements that would require them to be transparent and would require signatories "to introduce no new performance requirements and agree to review regularly the list of performance requirements, with a view to their reduction" (PECC, 1993, p. 16).

Overall, NAFTA is stronger with respect to the regulation of performance requirements than GATT because of its broader coverage. The North American Free Trade Agreement is also much stronger than the Pacific Eco-

nomic Cooperation Council draft for a code because the latter calls only for a standstill with no definitive rollback. Given that performance requirements can be distorting and that the adverse effects of the distortions introduced by an APEC member are likely to be borne by other countries in the APEC region, it would seem desirable that an APIC follow NAFTA's precedent. Indeed, the main issue might be whether or not some or all of the exceptions in NAFTA should be eliminated in an APIC.

There are a number of other issues that an APIC would need to address:

- *Multilateralization of obligations*

This issue is part of the broader question on the conditional versus unconditional most-favoured-nation treatment that must be addressed in any regional trade-liberalization agreement. Specifically, should APIC be extended by participating APEC member countries to TNCs from all countries or only to TNCs from countries subscribing to the code? Or, should each country subscribing to an APIC be able to decide for itself this question?

This third option is implicitly that of NAFTA. Mexico has decided to extend NAFTA Chapter 11, part A obligations unilaterally to foreign investors of all countries, while Canada and the United States have not. However, most NAFTA Chapter 11, part A investment obligations undertaken by the United States and Canada (where listed exceptions are integral adjuncts to the obligations) are consistent with existing law in the two countries (and with pre-existing OECD obligations) and hence have already been extended to third-party investors. The major exception to the multilateral extension of NAFTA obligations is that each member country can apply the dispute-settlement procedures of NAFTA only to foreign investors from other NAFTA members.

- *Minimum acceptable standards*

Under an APIC, as envisaged in this article, a strong right of establishment and the national treatment clauses would be tempered by transparent lists of reservations. Under this formula, no Government should be reluctant to sign an APIC because it could list any number of reservations.

But should there be a minimal level of openness required for accession to an APIC? Should a country whose reservations are very extensive, to the point where there are few industries subject to an unconditional right of establishment (apart from an initial screening on national security or other criteria) or national treatment, be allowed to sign on? If such a country were to be allowed to sign on, should it be required to commit itself to a programme of liberalization? Because this question of *minimum thresholds* may also arise in consideration of other issues, it is important in terms of the setting of a precedent, as well as in its own right.

- *Partial accession*

An issue closely related to the one above is whether an APEC country should be allowed to accept some (but not all) APIC obligations? For example, a country might be willing to accept obligations with respect to the right of establishment, national treatment and taxation (including the implicit obligations regarding transparency), but unwilling to accept obligations with respect to performance requirements. Should such a partial accession be allowed? If so, should obligations not accepted by that country not be extended to its investors by other APIC countries?

- *Voluntary versus mandatory*

It was agreed that, at least at the outset, an APIC would be a *voluntary* instrument, that is, a set of *non-binding* principles. Thus, it would be up to each APEC country to decide whether or not to implement the code. But APEC as a group must decide on whether or not to adopt the code in the first instance. This will require a clear decision, preferably by consensus, but perhaps by some other decision-making procedure, on the details discussed here. The process by which an APIC is adopted will have important precedent-setting implications.

Thus an APIC, as perhaps the first tangible action of the APEC members, will have important implications that range beyond its own substance, important as that may be. This is wholly appropriate since FDI has been at the core of the market-driven process of growing economic interdependence in the Asia-Pacific region.

A model for the future agenda of the World Trade Organization?

Not only would the creation of an APIC be an important precedent-establishing act for the APEC, but it could also be a model for a multilateral investment agreement lodged eventually in the World Trade Organization, the new international body to administer world trade rules established by the Uruguay Round of Multilateral Trade Negotiations. Foreign direct investment almost surely will be on the future trade agenda, but the writing of effective rules on FDI will be at best tricky (*The Economist*, 16-22 July 1994, pp. 55-56). Regional experiences with FDI agreements, such as within the NAFTA and, if an APIC comes into being, within the APEC region, will be invaluable when the time comes to write these rules.

The APEC region will, however, have competition in this domain. The Organisation for Economic Co-operation and Development, for example, is considering a multilateral investment agreement for its member countries (UNCTAD-DTCI, 1994). This agreement, if it is successfully concluded, would subsume and expand the existing OECD codes discussed earlier. Policy competition, such as between OECD and the APEC group may in fact be a good thing—it would be most desirable from a worldwide perspective for a number of such instruments to be created so that, if and when a truly international agreement is reached, it will benefit from the experiences of earlier and more limited agreements. The challenge for the APEC group is to create an instrument that is competitive in the sense that it would be substantively good enough to make a positive contribution to the international process of rule building in the area of FDI.

Postscript

In mid-November 1994, the APEC ministers endorsed a set of non-binding investment principles. These principles closely resemble the PECC draft investment code discussed in this article, prepared before their adoption. The principles did not meet the standards recommended by this author. It was noted by commentators that, in addition to the principles being non-binding, the language was often subject to ambiguous interpretation. However, it was further noted that the principles still have the potential to contribute to regional investment liberalization, if APEC countries were to bring national laws and policies into line with the spirit of the principles. Their stated goal is to facilitate FDI within the APEC region. Further work in the policy area was also called for. ■

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