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Trends and Determinants

Chapter III
INVESTMENT POLICY ISSUES

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CHAPTER III

INVESTMENT POLICY ISSUES

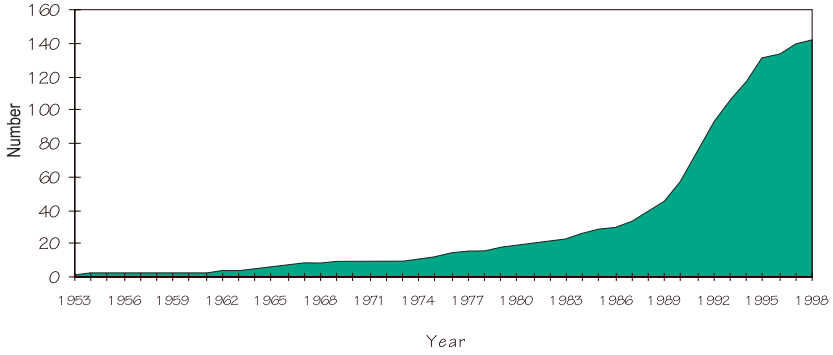
A. Trends

The trend towards a liberalization of national investment regimes has been accompanied by intensified international discussions and negotiations on FDI rules, which have generally complemented trends at the national level.

1. National policies

Over the past four decades, countries in all regions have come to adopt FDI-specific regulatory frameworks to support their investment-related objectives,[1] and every year a number of existing regimes are amended. By 1997, at least 143 countries and territories had enacted FDI-specific legislation (figure III.1 and table III.1). In 1997 alone, 17 countries introduced new foreign investment laws or substantially changed existing laws, and another 59 introduced regulatory changes with respect to one or more specific items affecting FDI. Initially, many investment laws were intended to control the entry and operations of foreign investors; since the early 1980s, however,

Figure III.1. Cumulative number of countries and territories with special FDI regimes, 1953-1998



Source: chapter III, table III.1.

Table III.1. Countries and territories with special FDI regimes,[a] 1998

Developed countries	Africa	Asia and the Pacific	Latin America and the Caribbean	Central and Eastern Europe[b]
Greece (1953)	Central African Republic (1963)	Kuwait (1965)	Brazil (1962)	Hungary (1988)
Turkey (1954, 1995)[c]	Kenya (1964)	Republic of Korea (1966)	Chile (1974)	Slovenia (1988)
Australia (1975)	Seychelles (1967, 1994)c	Pakistan (1976)	Argentina (1976)	Albania (1991)
Canada (1985)	Lesotho (1969)	Cook Islands (1977)	Barbados (1981)	Belarus (1991)
New Zealand (1985)	Liberia (1973)	Tonga (1978)	Panama (1983)	Croatia (1991)
Israel (1990)	Comoros (1982, 1992)c	Maldives (1979)	El Salvador (1988)	Estonia (1991)
Spain (1992)	Morocco (1983, 1995)c	Saudi Arabia (1979)	Bahamas (1990)	Latvia (1991)
Finland (1993)	Democratic Republic of the Congo (1986)	Bangladesh (1980)	Bolivia (1990)	Poland (1991)
Ireland (1994)	Rwanda (1987)	Bahrain (1984)	Trinidad and Tobago (1990)	Romania (1991)
Portugal (1995)	Senegal (1987)	Samoa (1984)	Colombia (1991)	Russian Federation (1991)
France (1996)	Somalia (1987)	Solomon Islands (1984)	Nicaragua (1991)	Slovakia (1991)
	Botswana (1988)	Qatar (1985)	Peru (1991)	Bulgaria (1992)
	Gambia, The (1988)	Viet Nam (1987)	Honduras (1992)	Czech Republic (1992)
	Gabon (1989)	Myanmar (1988)	Paraguay (1992)	Republic of Moldova (1992)
	Mauritania (1989)	Iran, Islamic Republi of (1990)	Venezuela (1992)	Ukraine (1992)
	Niger (1989)	Sri Lanka (1990)	Ecuador (1993)	The former Yugoslav Republic of Macedonia (1993)
	Togo (1989)	Taiwan Province of China (1990)	Mexico (1993)	Lithuania (1995)
	Zimbabwe (1989)	Tuvalu (1990)	Cuba (1995)	
	Benin (1990)	Iraq (1991)	Dominican Republic (1995)	
	Burundi (1990)	Niue (1991)	Jamaica (1995)	
	Cameroon (1990, 1994)[c]	Philippines (1991)	Uruguay (1998)	
	Sudan (1990)	Syrian Arab Republic (1991)		
	Mali (1991)	Thailand (1991)		
	Uganda (1991)	Yemen (1991)		
	Burkina Faso (1992)	Azerbaijan (1992)		
	Congo (1992)	Democratic People's Republic of Korea (1992)		
	Malawi (1992)	Nepal (1992)		
	Namibia (1992)	Papua New Guinea (1992)		
	Algeria (1993)	Mongolia (1993)		
	Cape Verde (1993)	Turkmenistan (1993)		
	Mauritius (1993)	Armenia (1994)		
	Mozambique (1993)	Cambodia (1994)		
	Sierra Leone (1993)	Indonesia (1994, 1995)[c]		
	Tunisia (1993)	Lao People's Democratic Republic (1994)		
	Zambia (1993)	Malaysia (1994)		
	Angola (1994)	Oman (1994)		
	Djibouti (1994)	Afghanistan (1995)		
	Eritrea (1994)	Bangladesh (1995)		
	Ghana (1994)	China (1995)		
	Côte d'Ivoire (1995)	Georgia (1995)		
	Guinea (1995)	Jordan (1995)		
	Nigeria (1995)	Palestinian territory (1995)		
	Libyan Arab Jamahiriya (1996)	Kazakhstan (1997)		
	Madagascar (1996)	Kyrgyzstan (1997)		
	Egypt (1997)	Micronesia, Federated States of (1997)		
	Ethiopia (1997)	Uzbekistan (1998)		
	United Republic of Tanzania (1997)			

Source: UNCTAD, based on national reports and various sources.

[a] Refers to a law or decree dealing specifically with FDI. This table does not cover provisions contained in laws or regulations that do not deal specifically with FDI, but are relevant to FDI.

[b] Includes developing Europe.

[c] The country has more than one set of legislation dealing with FDI.

Note: the year in which the prevailing legislation was adopted is indicated in parenthesis. Economies are listed according to the chronological order of their adoption of FDI legislation.

most countries have adopted frameworks designed to attract investors and create a favourable investment climate.[2]

Of a total of 151 regulatory changes made in 1997 by 76 countries, 89 per cent were in the direction of creating more favourable conditions for FDI, and 11 per cent in the opposite direction, a three per cent increase in the former over the preceding year (table III.2). The favourable changes included liberalizing measures as well as new incentives; the unfavourable changes increased control or reduced incentives.[3] During the period 1991-1997 as a whole, 94 per cent of the FDI regulatory changes were in the direction of creating a more favourable environment for FDI (table III.2), continuing a trend that started in the 1980s.[4] Liberalization moves in 1997 involved in particular the removal of operational conditions and the opening up of new industries to FDI (table III.3), sometimes through the revision of negative lists of industries previously closed to FDI. This was the case in both developing and developed countries. The majority of changes concerned the telecommunication and broadcasting industries. Streamlining approval procedures was also an important feature of legislative reform, particularly in Africa.

Table III.2. National regulatory changes, 1991-1997

Item	1991	1992	1993	1994	1995	1996	1997
Number of countries that introduced changes in their investment regimes	35	43	57	49	64	65	76
Number of regulatory changes	82	79	102	110	112	114	151
Of which:							
More favourable to FDI[a]	80	79	101	108	106	98	135
Less favourable to FDI[b]	2	-	1	2	6	16	16

Source: UNCTAD, based on national sources.

[a] Including liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives.
[b] Including changes aimed at increasing control as well as reducing incentives.

The legislative activity in 1997 was partly a response to international commitments. For example, a significant number of countries revised their intellectual property frameworks, following their commitments under the WTO Agreement on Trade-related Aspects of

Table III.3. National regulatory changes and their distribution, by type, 1997

Item	1997
Number of economies that introduced changes	76
Number of changes	151
- in the direction of more favourable conditions for FDI	
more liberal entry conditions and procedures[a]	3
more liberal operational conditions[b] and frameworks[a]	61
more incentives	41
more promotion (other than incentives)[c]	8
more sectoral liberalization	17
more guarantees and protection	5
- in the direction of less favourable conditions for FDI	
less incentives	7
more control	9

Source: UNCTAD, based on national sources.

[a] Includes changes applying across the board.
[b] Includes performance requirements as well as other operational measures.
[c] Includes free-zone regulations.

Intellectual Property (TRIPS), the Madrid Protocol and the European Union's Directives on Trademarks. The entry into force of the Fourth Protocol of the General Agreement on Trade in Services (GATS) on Basic Telecommunications Services also led to the further removal of impediments to FDI entry in the telecommunication industry, while the adoption of the Fifth Protocol of GATS on Financial Services (see below) is expected to relax limitations on the presence of foreign suppliers of financial services. Pursuant to commitments under the WTO Agreement on Trade-related Investment Measures (TRIMs), certain types of performance requirements have also been notified to the WTO, i.e. have been made more transparent (table III.4).[5]

Investment promotion is an area in which government activity is particularly noticeable. Incentives are still on the rise. During 1997, 36 countries introduced new incentives or strengthened existing incentives (mostly fiscal). At the same time, seven countries introduced measures to abolish incentives, particularly tax holidays.

Measures other than incentives, such as setting up investment promotion agencies and facilities, have also been taken to promote FDI. The trend towards establishing

Table III.4. Measures notified under Article 5.1 of the TRIMs Agreement, June 1998

Country	Type of measure	Sector
Argentina	Local content and trade balancing	Automotive industry
Barbados	Local content	Pork-processing industry
Chile	Local content and trade balancing	Automotive industry
Colombia	Local content	Automotive industry
	Local content and trade balancing	Agriculture
Costa Rica	Local content	General
Cyprus	Local content	Cheese and groundnuts
Dominican Republic	Local content	General
	Trade balancing	Pork
	Trade balancing	General
Ecuador	Local content	Automotive industry
Egypt	Local content	General
India	Local content	Pharmaceutical products
	"Dividend balancing" [a]	General
Indonesia	Local content	Automotive industry,[b] utility boiler, fresh milk and soybean cake
Mexico	Local content and trade balancing	Automotive industry
Malaysia	Local content	Automotive industry
	Local content	General
Nigeria	Local content	General
Pakistan	Local content	General
Peru	Local content	Milk and milk products
Philippines	Local content and foreign exchange balancing	Automotive industry
	Local content	Certain chemicals
Poland	Local content	Cash registers [c]
Romania	Local content	General
South Africa	Local content	Automotive industry
	Local content	Telecommunication equipment
	Local content	Tea and coffee
Thailand	Local content	Various designated products
Uganda	Local content	General
Uruguay	Trade balancing	Automotive industry
Venezuela	Local content	Automotive industry

Source: based on information provided by WTO.

[a] The term "dividend balancing" used in India's TRIMS notification describes a measure applied by India in 22 consumer goods industries which provides that, during a period of seven years after the start of commercial production, the amount of dividend that can be repatriated should be covered by the export earnings of the firm.

[b] In October 1996, Indonesia withdrew the part of its notification that concerned measures in the automotive industry.

[c] Poland has informed the TRIMs Committee of the elimination of this measure as of January 1997.

specialized schemes to attract foreign investors, such as export processing zones and free-trade and investment zones, was strong in 1997: eight countries either formulated free zone regulations or established new free zones in that year, adding to the substantial number of more than 800 such zones in existence in 102 countries (table III.5).

Table III.5. Export processing zones and free zones, by region, 1996

Region	Number of zones	Selected countries [a]
North America	320	United States - 213,[b] Mexico - 107
Asia	225	China - 124, Indonesia - 26
Europe	81	Former Yugoslavia - 9, Bulgaria - 8, Slovenia - 8
Africa	47	Kenya - 14, Egypt - 6, Sudan - 4
Caribbean	43	Dominican Republic - 27
Central America	41	Honduras - 15, Costa Rica - 9
Latin America	41	Brazil - 8, Colombia - 11
Middle East	39	Turkey - 11, Jordan - 7
Pacific	2	Australia - 1
Total	839	608

Source: WEPZA, 1997.

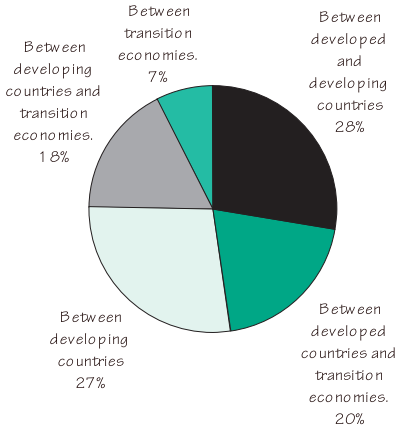
[a] Figures show the number of zones in a given country. The 18 countries shown, along with the United States, accounted for over 70 per cent of all zones worldwide. In addition, close to 100 other countries host export processing zones or free zones.

[b] The United States also has 380 sub-zones in manufacturing plants.

2. Developments at the international level

At the bilateral level, the network of bilateral investment treaties (BITs) has expanded further, with the total number of treaties having reached 1,513 by the end of 1997 (compared to 1,360 by the end of 1996). Of these, 249 were between developing countries. In 1997 alone, 27 per cent of the 153 treaties concluded that year were between developing countries (figure III.2). The number of countries that have signed BITs has increased from 165 in 1996 to 169 in 1997. Apart from BITs, bilateral treaties for the avoidance of double taxation have also become quite numerous, and are discussed separately in the last section.

Figure III.2. BITs concluded in 1997, by country group[a]



Source: UNCTAD, database on BITs.

[a] In 1997, 153 BITs were concluded.

At the regional, plurilateral and multilateral levels, discussions or negotiations on the development of investment rules have proceeded in various forums. While there are considerable differences regarding the pace, scope and depth of these discussions and negotiations, one thing they have in common is that representatives of civil society (box III.1) are increasingly paying attention to them (box III.2).

- At the Second Summit of the Americas in Santiago de Chile on 19 April 1998, the countries of the region launched negotiations for a "Free Trade Agreement of the Americas" (FTAA) which is expected to be concluded by 2005. The agreement is to be balanced, comprehensive and WTO-consistent and would constitute a single undertaking. Its negotiating process is to be transparent and to take into account the differences in levels of development and size of the economies in the region in order to create opportunities for full participation by all countries.[6] The negotiations on investment rules are to build on the efforts already initiated by

Box III.1. Defining civil society

The idea of "civil society" seeks to capture the way in which the world appears to be changing politically, at the heart of which is a shift in the relationship between the state and citizenry. While civil society can be seen as a counterbalance to the state, both are inextricably linked. Civil society is a "work in progress" which, while existing throughout much of the world in different shapes and forms, at different levels of organization, capacity and strength, is a socio-political reality whose continuing expansion demands active support if the goals of development, democracy and human rights are to be realized. In this sense, the building of civil society can be seen as an objective whose achievement must be purposefully and actively sought, in order to achieve wider economic, political and social goals.

Traditionally, the United Nations has employed the term "NGO", cited in the United Nations Charter, to define a relatively limited universe of non-state actors, particularly international (but sometimes national) non-governmental organizations active in the fields of development, disarmament, women's equality and human rights. However, civil society as a whole is made up of NGOs, community-based and grass-roots organizations, professional associations, representative bodies of the enterprise and financial communities, trade unions, the media, academic institutions, professional guilds and a range of major social interest groups, all providing an interface between citizens and the state. Until recently, civil society has been defined, and perceived, only in the national context. However, that is now changing rapidly and the civil society with which international organizations work is itself in the process of becoming globalized, reflecting the globalization of issues.

One area where there is a lack of definitional clarity is whether the private business sector should be included in the definition of civil society. Non-profit, value- and aspiration-driven organizations of civil society usually reject the notion that they belong to the same category of organizations as private enterprises driven by the profit motive. The reverse is also the case. However, some forums (including UNCTAD) have accepted that non-profit business associations and cooperatives could be treated as part of civil society. It is also necessary to consider whether trade unions created within the private sector, but with a role that takes them beyond their social origins when they seek to influence state employment policies, should be treated differently.

A case can also be made that national parliaments, and thus also their members, should be treated as a separate category, distinct from civil society, as the legislative branch of government.

Given the sheer diversity of the institutions that comprise -- and represent -- civil society and the private sector all over the world, an absolute definition that excludes business from civil society is perhaps not very helpful. However, one useful way to regard both NGOs and the business community, in whatever form the latter organizes itself, is as interest groups concerned with advancing their own agenda through the United Nations.

Source: UNCTAD (forthcoming, a).

Box III. 2. NGOs and international rules on investment

The late 1990s might come to be remembered as the time when non-governmental organizations (NGOs) first became a force in international economic policy-making and when the principles of participation, consultation and sustainable development gained increasing acceptance in shaping international debate. NGOs are likely to remain a force to be dealt with in the foreseeable future. One indicator of their influence is the role they played with regard to the negotiations of the Multilateral Agreement on Investment (MAI) in the Organisation for Economic Co-operation and Development (OECD).

Many NGOs pursue a step-by-step strategy. The first is to approach a relevant domestic ministry, e.g. the environmental ministry of a member of the European Union. Should this fail, the national legislative assembly (i.e. the parliament) may be approached. The final approach is to civil society generally at national and international levels. Some NGOs put more emphasis on lobbying via civil society from the very outset of their work on an issue.

Certain NGOs have had a long involvement in at least some international economic debates and negotiations on which they have had an impact, such as, for example, the negotiations on the draft United Nations Code of Conduct on Transnational Corporations (UNCTAD, 1996b), the Guidelines on Consumer Protection (UNCTAD, 1996b), and the Rio Earth Summit and the GATT/WTO -- all in the

/...

(Box III.2, concluded)

late 1980s and early 1990s. In more recent years, the availability of such a facility as the Internet has greatly enhanced the capacity of NGOs to share information, coordinate their efforts and connect with a global audience, including an audience in developing countries, with up-to-the-minute material. The importance of new technological tools and the increasing organization and sophistication of NGOs cannot be understimated; according to a commentator, "some think it could fundamentally alter the way in which international economic agreements are negotiated".[a]

The involvement of NGOs in international economic negotiations can be traced to at least 1988 when the United States, at the request of the Earth Island Institute in California, enforced a provision of the Mammals Protection Act (1972) relating to the high mortality rate of dolphins when tuna were caught with purse-seine nets; since tuna swim below dolphins, some dolphins were caught and drowned in the purse-seine nets. Mexico disputed this decision and brought the United States to a General Agreement on Tariffs and Trade (GATT) -- now World Trade Organization -- dispute panel (Lindert and Pugel, 1996). The GATT panel found that the United States decision was inconsistent with GATT rules. This decision upset environmentalists worldwide and suggested to many of them that the multilateral trade rules were indifferent if not inimical to environmental concerns. Some environmental NGOs took the position that a change was needed in the GATT/WTO rules to make them more "environmentally friendly"; others felt that the whole system needed to be reviewed. In the subsequent debates over the North American Free Trade Agreement (NAFTA) in 1995, some NGOs opposed NAFTA whereas others sought to modify it to take environmental and labour issues into account.

In late 1996, the focus of many NGOs already working on trade, investment and development issues shifted in part to the OECD, where the MAI was under negotiation. Concerns of NGOs in this domain have been exacerbated by a suit brought against the Government of Canada by the United States Ethyl Corporation under provisions of the NAFTA that are similar to the proposed MAI provisions. Ethyl claimed that the decision by the Government of Canada to ban the import and transport of MMT -- a petrol additive produced by Ethyl that is allegedly considered to have an adverse effect on the operation of vehicle pollution control components -- was effectively 'expropriation' since it reduced the value of the company's assets. NGOs feared that, were the Government of Canada to lose this suit, there would be major legal repercussions in the area of the environment and public health and safety.

The case in Canada, and the general situation flagged by the NGOs, falls under the rubric of a "regulatory taking": a situation where, by virtue of the implementation of a law or regulation by a government, the assets of a private party lose value. The issue is relevant because, in the draft language of the MAI, it appeared to some that a regulatory taking affecting a foreign investor might qualify as an expropriation and hence be subject to compensation. If it were so, the investor-state dispute-settlement procedure could well decide in a given case that a regulatory taking constituted an expropriation. NGOs are concerned that much environmental law and regulation might be undone if governments grow fearful of endless and costly lawsuits by foreign investors under the MAI.

Perhaps the main contribution of recent NGO campaigns has been in moving the debate on international investment rules away from narrow technical issues and towards a wide-ranging discussion of regulation and globalization. This shift was emphasized in the OECD Ministerial Statement (OECD, 1998a), which devoted much attention to the need for governments to engage in a discussion with "interested groups in their societies" over the process of globalization and the implications of the MAI.

In brief, NGOs have established themselves as a force to be reckoned with in discussions and negotiations over international rules on investment. These organizations are likely to continue to play a role in such negotiations, whether at the OECD or in some other forums. Indeed, the ongoing debate is a clear reminder that FDI issues, which by their very nature touch on the entire range of matters relating to production and the production process, raise complex questions of national policy in both developed and developing countries. If broad consensus is to be achieved, it is thus essential that international investment discussions and negotiations involve all those potentially affected. This is the logical consequence of the internationalization of the domestic policy agenda.

Source: Graham, 1998.

[a] "Network guerillas", *Financial Times*, 30 March 1998.

the FTAA Working Group on Investment (box III.3) and "aim to establish a fair and transparent normative framework to promote investment through the creation of a stable and predictable environment to protect the investor, his investment and related flows, without creating obstacles to investments from outside the hemisphere."[7] A Negotiating Group on Investment was established for this purpose. In June 1998, during the first meeting of the FTAA Negotiations Committee, it was agreed that the Negotiating Group on Investment "should develop a framework incorporating comprehensive rights and obligations on investment, taking into account the areas already identified by the FTAA Working Group on Investment and develop a methodology to consider potential reservations and exceptions to the negotiations."[8] Furthermore, the San Jose Declaration recognizes and welcomes the interests and concerns that different sectors of society have expressed in relation to the FTAA -- in particular business, labour, environmental and academic groups -- and encourages these and other sectors of civil societies to present their views on the topics under negotiation in a constructive manner. To that end, it establishes a committee of government representatives to receive inputs from civil society groups and present a range of views for the consideration of ministers.

- Also on the American continent, on 17 June 1998, the four members of MERCOSUR and Canada signed a "Trade and Investment Cooperation Arrangement" aimed at enhancing economic relations between the parties, in particular in the areas of trade and investment. The arrangement establishes a plan of action which foresees a framework for negotiating bilateral investment agreements, cooperation on customs matters, and the identification of measures distorting or hindering trade and investment. Furthermore, this plan of action provides for cooperation in the WTO and other appropriate forums on issues of common interest as well as consultations on the negotiation and implementation of the FTAA. The arrangement also establishes a council of business representatives from the member countries to advise the parties on areas of particular concern to the private sector.

Box III.3. Preparing for negotiations on investment rules in the FTAA

The Working Group on Investment met between September 1995 and March 1998. It had two objectives:

- To present to the governments of the region a precise and clear assessment of the existing normative frameworks applicable to foreign investment in the American continent, as well as a description of inward and outward investment flows in the region.
- On the basis of such an assessment and description, the Working Group was to prepare for the negotiations on a future investment chapter of the FTAA by promoting an exchange of ideas among countries on the regulatory alternatives available to them.

The Group was asked to begin by developing two inventories, one of the existing investment agreements within the region and the other of the national investment regimes in the continent. On the basis of these inventories, the Group was then to identify the areas of convergence and divergence in the national and international frameworks.

As for convergence, the Group found that practically all countries of the American continent offered constitutional protection to the basic principles of private property, freedom of enterprise, /...

Box III.3 (concluded)

equality between foreigners and nationals, and due process of law. All investment agreements between countries in the region are based on the principles of national treatment and most-favoured-nation treatment, and many include basically the same exceptions to most-favoured-nation treatment (i.e. economic integration schemes, tax treaties and bilateral concessionary finance schemes). Most national regimes and investment agreements are committed to allowing transfers of capital related to an investment in a freely convertible currency and at the exchange rate prevailing on the day of the transaction, without prejudice to exceptions in cases of serious balance-of-payments problems. There is convergence regarding the justification of an expropriation decree and the criteria used to determine the amount of compensation, the means of payment and the due process guarantees to be followed. Finally, there is also a great similarity between the agreements with respect to settlement of disputes, not only with respect to disputes between the parties but also with respect to disputes between investors and host countries, and many of the countries of the FTAA are members of ICSID or are in the process of adhering to it.

The main areas of divergence were found to lie in the definition and scope of the concept of foreign investment, as well as in the criteria for determining the nationality of juridical persons; the processes of authorization and registration of foreign investment, including the existence of a national authority specifically responsible for these matters (different powers being held by sub-national authorities in different countries); the scope of the application of national treatment and most-favoured-nation treatment, in so far as some agreements grant national and most-favoured-nation treatment only to investments already established in accordance with national legislation, while others grant such treatment at the pre-establishment phase; and the industries that are open to foreign investment.

With respect to its second objective, the Group identified various perspectives and options for dealing with key substantive elements of an investment agreement. More specifically, it recommended the following:

- With respect to the objectives of the negotiations, the Group recommended that these should aim at establishing a fair and transparent legal framework conducive to a stable and predictable investment climate to protect investors, their investments and related flows, and stimulate investment opportunities while avoiding unjustifiable obstacles to extra-hemispheric investment.

- Regarding the substance of the negotiations, the Group recommended that the negotiation should include, at a minimum, the principles of non-discrimination, national treatment, most-favoured-nation treatment and fair and equitable treatment. In addition, the Group identified 12 substantive issues that will be subject to negotiation (without prejudice to the possibility that, during the negotiations, other relevant issues may be agreed upon): basic definitions, scope of application, national treatment and sectoral reservations, most-favoured-nation and sectoral reservations, fair and equitable treatment, expropriation and compensation, compensation for losses due to armed conflicts, admission of managerial personnel, transfers of funds, performance requirements, general exceptions and settlement of disputes.

- On possible approaches to the negotiations, two options were discussed. The first option was the negotiation of a chapter on investment that would establish obligations of general application, allowing for clearly defined reservations and exceptions on them. To achieve this, the chapter on investment would be divided into three areas: definitions, principles and obligations of general application; mechanisms for the settlement of investment disputes; general exceptions and specific reservations to the general obligations. The second option was to engage in three activities: to expand and deepen the statistical study on investment flows in the Hemisphere with a view to arriving at the harmonization of national statistical systems; to focus the negotiations only on the question of scope and coverage, in order to establish a transparent, comprehensive and balanced normative framework, to continue discussions on specific issues on which there is already convergence at the national level; and to continue the interaction with the private sector through seminars, conferences and workshops.

Source: Anabel Gonzalez, President, Negotiating Group on Investment, Free Trade Area of the Americas.

- At the ASEAN Bangkok Summit Meeting in 1995, members decided to enhance ASEAN's FDI attractiveness. The thrust of the work being carried out, as described in the ASEAN Plan of Action on Cooperation and Promotion of Foreign Direct Investment and Intra-ASEAN Investment, involves cooperation on programmes for the promotion of FDI and intra-ASEAN investment; consultations and exchange of information and experiences among ASEAN investment agencies on a regular basis; creation of an Investment Unit within the ASEAN Secretariat; joint training programmes for investment officials; simplification of investment procedures and enhancement of transparency in investment policies; and other measures to promote greater intra-ASEAN investment by facilitating the effective exploration of the region's comparative and complementary locational advantages. These various activities are to be consolidated in a framework agreement on the ASEAN Investment Area, which is expected to be signed later in 1998. It would be based on three pillars: cooperation and facilitation; promotion and awareness; and liberalization programmes. The investment initiative being discussed in ASEAN, for now, differs from the rule-oriented approach adopted in other regional integration frameworks by being designed to encourage investment through voluntary cooperation amongst members, while avoiding legally binding commitments and dispute settlement mechanisms. Thus, the ASEAN Investment Area proceeds mainly through an approximation of objectives, strategies and practices, while emphasizing policy flexibility and informal consultations to resolve difficulties (Bora, forthcoming).

- Work has continued in the OECD with regard to the negotiations on a Multilateral Agreement on Investment (MAI), initiated in 1995. At the April 1998 ministerial meeting, the ministers decided to allow for a period of assessment and consultations, in order to deal with outstanding difficulties (OECD, 1998a). Ministers recognized in particular that, while the agreement needed to ensure a high standard of liberalization, it also needed to take into account economic concerns and political, social and cultural sensitivities; that it needed to be consistent with the sovereign responsibility of governments to pursue domestic policies; and needed to address environmental and labour issues, among others. They also stressed their commitment to a transparent negotiating process and to active public discussions on the issues at stake. A number of non-OECD member countries were welcomed to participate as observers (box III.4).

  One of the high points in the recent MAI negotiations was the meeting of the MAI Negotiating Group with non-governmental organizations (NGOs) in October 1997,[9] after the text of the draft agreement was made public through the Internet (www.OECD.org/ daf/cmis/mai/maindex.htm). Since then, the MAI has attracted wide attention, not only among NGOs but also in a number of parliaments, including the European Parliament. The overarching concern of NGOs is that the rights bestowed upon foreign investors by the MAI be balanced by a requirement to meet environmental and social responsibilities, the latter including the right of countries and communities to manage their own development. They have stressed the need to ensure that key MAI provisions on, for example, general treatment and expropriation cannot be construed to undermine the regulatory powers of government. This was all the more important, they argued, in the light of the special treatment given to foreign

Box III.4. The OECD Multilateral Agreement on Investment: state of play as of July 1998

In April 1998, the negotiations on a Multilateral Agreement on Investment (MAI) in the OECD reached a critical stage. The negotiations had begun formally in 1995. Between September 1995 and early 1997, the negotiating process was mostly of a technical nature. Between early 1997 and the OECD ministerial meeting of April 1998, negotiators had been under increasing pressure from non-governmental organizations and others to increase transparency and seek broad-based political support. Partly as a result of these pressures, a pause for reflection was agreed to by the ministers, to last until October 1998. The following paragraphs describe the objectives, basic principles, main features and main outstanding issues as they have emerged from the negotiation process and the draft agreement so far:

The MAI is intended to provide a broad multilateral framework for international investment with high standards for the liberalization of investment regimes, the protection of investment, and effective dispute-settlement procedures. It seeks to provide predictability and security for international investors and their investments, and thus promote economic growth and efficiency, sustainable development and employment, and rising living standards for both developed and developing countries (Witherell, 1995; Engering, 1996).

Basic principles

- The MAI addresses investors and investments, including their establishment, expansion, operation and sale. Investment will be defined broadly to include enterprises, real estate, portfolio investments, other financial instruments and intangible assets.
- The MAI is meant to be a free-standing international treaty open to all OECD members and the European Community and to accession by non-members willing and able to meet its obligations. In reviewing proposals for adherence to the MAI, the parties would give full consideration to the particular circumstances of each country, including country-specific exceptions to accommodate the applicant's development interests. Eight non-members currently participate as observers.[a] In addition, there is an ongoing dialogue with non-member countries, with business and labour, and with non-governmental organizations.
- Country-specific exceptions would be an integral part of the agreement, and MAI disciplines would not apply where specific exceptions had been agreed to. Negotiators are aiming for a set of disciplines and exceptions that would achieve a high standard of liberalization and a satisfactory balance of commitments, taking full account of economic concerns and political, social and cultural sensitivities.
- There is increased convergence of views on the need for the MAI to address environmental and labour issues. There is broad support for including a strong commitment by governments not to lower environmental or labour standards in order to attract or retain investment. Furthermore, the MAI seeks to be consistent with the sovereign responsibility of governments to pursue their policy objectives. The MAI would not inhibit the normal non-discriminatory exercise of regulatory powers by governments. Investors would not be able to challenge domestic regulations as *de facto* expropriation.

Main features

Core MAI rules:

- *Transparency*: publication of laws and regulations affecting investments.
- *National treatment:* foreign investors and investments to be treated no less favourably than domestic investors and investments.
- *Most-favoured-nation treatment:* investors and investments from one MAI party to be treated no less favourably than those from another MAI party.
- *Transfer of funds:* investment-related payments (including capital, profits and dividends) must be freely permitted to go to and from the host country.

/...

(Box III.4, concluded)

- *Performance requirements:* targeted prohibitions on certain requirements imposed on investors, such as minimum export targets for goods and services, local content rules or technology transfer requirements.
- *Expropriation:* may only be undertaken for a public purpose, with prompt, adequate and effective compensation.
- *Dispute settlement:* provision for resolving disputes through consultations, with recourse, if necessary, to binding arbitration of disputes between states and between foreign investors and host states.

Exceptions to MAI rules:

- *General exceptions*: any country would be able to take measures necessary to protect its national security or to ensure the integrity and stability of its financial system.
- *Temporary safeguards:* provisions to enable countries to take measures necessary to respond to a balance-of-payments crisis.
- *Country-specific exceptions:* negotiated among MAI parties, they will permit each country to maintain non-conforming laws and regulations.

Furthermore, the MAI would not:

- mandate detailed domestic measures affecting investment, nor require member countries to adopt a uniform set of investment regulations;
- prevent parties from providing funds for domestic policy purposes; and
- require parties to accept each others' product or service quality or safety standards.

The OECD Guidelines on Multinational Enterprises -- a code of good business conduct setting out OECD members' expectations behaviour and activities of TNCs -- would be annexed to the MAI without changing their status as non-binding recommendations.

Main outstanding issues

- Liberalization and exceptions: proposed exceptions to most-favoured-nation treatment for regional integration schemes (REIO clause); cultural exceptions; current lists of reservations to the MAI; flexible regime of standstill on new non-confirming measures.

- Labour standards: whether there should be a provision prohibiting lowering labour standards to attract or retain an investment; whether the MAI should explicitly support internationally recognized core labour standards.

- Environmental protection: the objective is to ensure that the MAI does not stimulate "pollution havens", is consistent with multilateral environmental agreements, and does not prevent the parties from setting national environmental standards for investment, both foreign and domestic.

- Conflicting jurisdictions: this issue arose because of the adoption in one country of two laws that would directly affect investors from third countries. A tentative agreement reached on this issue in May 1998 between the United States and the European Union appears to contain elements for possible inclusion in the MAI.

In March 1998, the Chairperson of the Negotiating Group put forward a package proposal which included the following elements: language for the preamble; a qualification on national treatment; a binding provision on non-lowering of standards on health, safety, environment and labour measures; an interpretative note regarding the articles dealing with general treatment and expropriation aimed at making clear that the MAI would not inhibit the exercise of normal regulatory powers of government (particularly in the area of environment); and a cross-reference to the OECD Guidelines on Multinational Enterprises.

Source: OECD materials.

[a] Argentina; Brazil; Chile; Estonia; Hong Kong, China; Latvia; Lithuania; and the Slovak Republic.

investors through the investor-state dispute-settlement provisions which would allow these issues to be decided by international expert tribunals. The NGOs also called for the MAI to include provisions on labour rights and consumer and environmental standards in order to ensure that the removal of barriers to FDI did not lead to a lowering of standards in these areas. Some special interest groups such as authors and film-makers called attention to the threat that the MAI could pose for preserving cultural identity. Many of these and other concerns were also shared by the European Parliament in a "Resolution containing Parliament's recommendations to the Commission on negotiations in the framework of the OECD on a multilateral agreement on investment (MAI)" (box III. 5). Finally, NGOs believe that, as it stands, the MAI is unbalanced with respect to the rights and obligations of foreign investors and that adding non-binding guidelines for the behaviour of foreign enterprises to the MAI's legally binding provisions on investment protection would not be sufficient to rectify the balance. In fact, some NGOs (e.g. Consumer Unity and Trust Society (CUTS) and the Council of Canadians (CoC) have prepared alternative texts to those in the MAI draft (CoC, 1998; CUTS, 1998).[10]

Box III. 5. Resolution containing Parliament's recommendations to the Commission on negotiations in the framework of the OECD on a multilateral agreement on investment (MAI)

(Excerpts)

The European Parliament

- having regard to its resolution of 14 December 1995 on the Commission communication entitled 'A level playing field for direct investment worldwide',[a]

....

D. concerned that the draft multilateral agreement on investment (MAI) reflects an imbalance between the rights and obligations of investors, guaranteeing the latter full rights and protection while the signatory states are taking on burdensome obligations which might leave their populations unprotected,

E. whereas the MAI must not only provide benefits to the industry and the countries of origin, but should also contribute to responsible development of the country of establishment by promoting technology, sustainable economic growth, employment, healthy social relations and protection of the environment,

F. whereas the aim of an MAI should be to prevent ruinous competition between investors which would be harmful to the populations concerned in order to foster, on a global scale, environmentally and socially sustainable and regionally balanced economic development,

G. regretting the fact that the negotiations have hitherto been conducted in the utmost secrecy, with even national parliaments being excluded, although transparency and parliamentary supervision in key international economic issues are of crucial importance for the legitimacy of relevant international agreements,

H. whereas the EU has not yet supplied any studies on the impact of the MAI on trade, commerce and the labor market or intellectual property and whereas the compatibility of the MAI with existing environmental, social and cultural legislation and legislation on intellectual property rights in the EU, relations with the ACP countries and the EU's development policy, and its relationship with international environmental agreements (MEA), international conventions on intellectual property and regional agreements (REIO) have still not been clarified.

I. puts to the Commission the following recommendations:

1. Emphasizes the need for a broader public debate and ongoing parliamentary monitoring of the negotiations being conducted within the framework of the OECD, bearing in mind that the decisions to conclude an agreement are a matter for the state and national parliaments, the European Parliament and the Council;

/...

(Box III.5, continued)

2. Calls on the Commission, within a reasonable period, to carry out an independent and thorough impact assessment in the social, environmental and development fields, investigating to what extent the draft MAI is in conflict with:

(a) relevant international agreements, such as the Rio Declaration, Agenda 21, the UN Guidelines on Consumer Protection (1985), the UNCTAD Set of Multilaterally Agreed Principles for the Control of Restrictive Business Practices(1981) and the HABITAT Global Plan of Action and international commitments already entered into by the OECD;

(b) previously agreed OECD guidelines, such as the undertaking to integrate economic, social and environmental policy (May 1997), agreements on the responsibilities of multinational enterprises, as laid down in the OECD Code of Conduct of 1992, and OECD policy on development cooperation as formulated in 'Shaping the 21st century: the contribution of development cooperation' (1997);

(c) regional, national and EU legislation designed to promote sustainable development.

3. Notes that non-OECD member states, and hence developing countries in particular, may also accede to the agreement under negotiation, but regards the fact that those countries may not themselves exert any influence on the content of the agreement as a major shortcoming of the MAI, and calls on the states involved in concluding the MAI to refrain from exerting any pressure on the developing countries in order to induce them to accede to it;

...

5. Calls for the question of investment protection to be examined in a multilateral context in which all the developing countries are involved, so that UNCTAD, as well as the WTO, would be the appropriate forum for these negotiations; the WTO's consideration of this question must take full account of the results of the UN conferences, particularly with regard to the environmental and social dimensions;

6. Stresses that it is essential that the principle of partnership, which is now accepted both by the OECD and by the G8 as the basic characteristic of relations between developed and developing countries, should be respected, so that the interests of the developing countries and their national policies are taken into account as well as the interests of investors;

....

11. Considers it necessary for a derogation to be made for balance-of-payments disequilibria coupled with a provision to deter parties from abusively invoking balance-of-payments problems;

12. Is concerned that the performance requirements might curtail the right of States to implement existing industrial policies and to develop any new ones as required in future, particularly in the field of social and environmental legislation, culture and intellectual property, and fears that EU Member States may come under pressure in these areas in the next few years;

13. Calls on the Commission, therefore, in formulating prohibitions of specific performance requirements, to ensure that the latter do not conflict with the environmental social, structural and cultural policies of the EU and its Member States;

14. Insists further that reference should be made to compliance with international human rights conventions and environmental and social standards not only in the preamble of the MAI and that the MAI should contain unequivocal provisions which prevent a lowering of existing environmental and social standards by the MAI and make possible the introduction of new standards;

/...

- In 1997, the OECD adopted the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (OECD, 1997a). The Convention seeks to establish high standards for national and international measures to combat bribery by public officials in international business transactions, including foreign investment, thus avoiding the distortions that bribes can introduce in the international flow of investment.[11] Another plurilateral instrument addressing this problem is the Inter-American Convention against Corruption which was opened for signature in March 1996 (OAS, 1996). The Convention in particular prohibits -- subject to the constitutions and fundamental principles of the legal systems of the states parties -- any act of

(Box III.5, concluded)

15. Welcomes the inclusion of the OECD guidelines for multinational undertakings as a an annex to the MAI, but advocates that those guidelines should constitute a compulsory component of the MAI and calls in any case in this connection on the governments of the Member States to encourage international enterprises to draw up their own codes of conduct comprising provisions in the field of environmental protection, human rights and social matters;

....

18. ... EU legislation and preventing further harmonization of EU legislation; insists, therefore, on the insertion of a separate part of a Regional Economic Integration Organization (REIO) clause permitting new harmonized measures, e.g. environmental legislation, adopted within the framework of such an organization and replacing the measures previously applied by these States; takes the view that countries belonging to REIOs are not obliged to extend to countries not belonging to the organization concerned the more favourable treatment reserved for member countries;

....

21 Calls for the invoking of national security interests to be made subject to objective criteria which are verifiable under the disputes settlement procedure; in this connection also advocates the inclusion of an anti-abuse clause;

....

23. Considers the proposed provisions on investment protection, and in particular on expropriation, compensation and the transfer of capital and profits, to be too far-reaching; takes the view that governments must make sure that they cannot be condemned to making compensatory payments if they establish standards on the environment, labor, health and safety;

....

37. Calls on the Commission, the Council and the Member States to submit, pursuant to the procedure provided for in Article 228(6) of the EC Treaty, the definitive draft of the MAI to the Court of Justice for full examination;

....

IV. Calls on the parliaments and governments of the Member States not to accept the MAI as it stands:

....

VI. Instructs its President to forward this resolution to the Council, the Commission, the governments and parliaments of the Member States and the Secretariat of the OECD.

Source: European Parliament, 1998.

a *Official Journal of the European Commission,* 22 January 1996, p. 175.

bribery involving international economic transactions; suggests a number of preventive measures (including measures aimed at promoting accountability, transparency and the involvement of civil society); seeks to strengthen intergovernmental cooperation; and aims at fostering the progressive development and hamonization of domestic laws in this area.

- In Europe, the Energy Charter Treaty (UNCTAD, 1996b, vol. I) entered into force on 16 April 1998 and, by the end of June 1998, 38 countries had ratified it (www.ENCHARTER.ORG). Moreover, the negotiations on a Supplementary Treaty regarding investment and an amendment to the Energy Charter Treaty's trade provisions were concluded in December 1997 (www.ENCHARTER.ORG). As regards investment, the Energy Charter Treaty contains an obligation to accord non-discriminatory post-investment treatment without exceptions. In this context, non-discrimination means the better of two standards: MFN treatment and national treatment. For the pre-investment phase, however, its investment provisions contained only a best-endeavour commitment with respect to non-discrimination and provided that the Supplementary Treaty would deal with the conditions for a legally binding non-discrimination obligation for the pre-investment phase. The Supplementary Treaty, as negotiated, provides for two types of exceptions from the non-discrimination principle. First, it grandfathers existing restrictions; these exceptions are set out by each country, listing each nonconforming measure in an annex to the treaty. The text also provides an option for listed countries to reserve all or some of the state's shares or assets that are being privatized to its own nationals.

- At the multilateral level, the Fourth Protocol to the General Agreement on Trade in Services (GATS) on Basic Telecommunications Services was concluded in 1997 in the framework of the WTO. It entered into force on 5 February 1998. Among other things, it contains commitments to open market access for FDI entry in telecommunication service industries (WTO 1997a; see UNCTAD 1997a, box V.18 for a summary description).

- The WTO negotiations of schedules on financial services were concluded on 12 December 1997. The results were attached to the Fifth Protocol to the GATS on Financial Services (WTO, 1997b) which is expected to enter into force by March 1999. These negotiations led to new and expanded commitments on the liberalization of market access for financial services, including market access through commercial presence, which typically involves all forms of FDI entry. In fact, as in other service industries, a large part of commitments on financial services concern commercial presence. The new commitments relate, among other things, to the elimination or relaxation of limitations on foreign ownership and control of local financial institutions (particularly through increase of foreign equity to more than 50 per cent), limitations on the juridical form of commercial presence (branches, subsidiaries, agencies, representative offices, etc.) and limitations on the expansion of existing operations. Some commitments involve "grandfathering" of existing branches and subsidiaries of foreign financial institutions that are wholly owned or majority-owned by foreigners. Commitments were made in all of the three major financial service sectors --

banking, securities and insurance -- as well as in other services such as asset management and the provision and transfer of financial information. More countries made commitments in banking than in securities. Commitments in insurance were increased in number and depth. With five countries making commitments in financial services for the first time, the total number of WTO members with commitments in financial services will increase to 102 upon the entry into force of the Fifth Protocol. These commitments may be particularly important for some developing countries which have only recently started to adopt market reforms in financial services. Indeed, given the close interrelations between financial services and macroeconomic policy, and the strategic role of services industries in influencing the allocation of financial resources and ultimately in attaining development objectives, governments have traditionally assumed a major role, both as providers and as regulators of financial services.

Finally, financial services have unique characteristics: financial stability and investor protection are crucial policy objectives in all countries, with potential effects on all other economic activities. In the light of these, such services were provided with a prudential carve-out in the GATS Annex on Financial Services, and some countries have also chosen to schedule measures that may be characterized as prudential measures but could be challenged as limitations on market access or national treatment in the future.

- Work has also proceeded in the WTO Working Group on the Relationship between Trade and Investment on the basis of a list of issues that were identified for examination and discussion. These cover four broad areas: implications of the relationship between trade and investment for development and economic growth; the economic relationship between trade and investment; stocktaking and analysis of existing international instruments and activities regarding trade and investment; and the identification of common features and differences between the two areas, including overlaps, possible conflicts and gaps in existing international instruments (box III.6).

UNCTAD, in accordance with its mandate, is pursuing a number of activities relating to international investment agreements. Their main purpose is to help developing countries participate as effectively as possible in international discussions and negotiations on FDI in which they choose to participate, be it at the bilateral, regional, plurilateral or multilateral level (box III.7). More specifically, and with a view to consensus-building, the work programme concentrates on deepening the understanding of the issues involved in international investment instruments; exploring the range of issues that need to be considered; helping to identify the interests of developing countries; and ensuring that the development dimension is understood and adequately addressed. In this context, UNCTAD -- with the active participation of principal groups in civil society -- is paying special attention to issues related to the development friendliness of international investment agreements (box III.8).

* * *

An attempt to assess the above processes at this stage would of course be premature. But the outcomes of some of the discussions permit at least a few preliminary observations:

Box III.6. The WTO Working Group on the Relationship between Trade and Investment

The General Agreement on Tariffs and Trade (GATT) was concerned with measures affecting cross-border trade in goods. The World Trade Organization (WTO), its successor organization, is concerned with the treatment of foreign enterprises and natural persons as well. However, the treatment of foreign investment in the WTO Agreements is rather fragmented and limited in comparison with other existing international investment arrangements. In recent years, not only have FDI flows continued to increase but the pattern of these flows has changed considerably, as the proportion of FDI flowing to developing countries has increased rapidly. These developments have been supported by the liberalization of national investment laws and the proliferation of bilateral and regional investment agreements which in turn have facilitated complementary links between trade and investment. These and similar factors led to the establishment of the WTO Working Group on the Relationship between Trade and Investment at the first WTO Ministerial Conference, held in Singapore in December 1996.

The creation of the Working Group reflects a compromise between various views. The Singapore Ministerial Declaration requires the Group to examine the relationship between trade and investment, while stating *inter alia* that:

- the work in this Group shall not prejudge whether or not negotiations will be initiated in the future;
- the Group shall cooperate with UNCTAD and other appropriate international fora to make the best use of available resources and to ensure that the development dimension is taken fully into account;
- the WTO General Council will determine after two years how the work should proceed;
- future negotiations, if any, regarding multilateral disciplines will take place only after an explicit consensus decision is taken among WTO members regarding such negotiations; and
- the Working Group on the Relationship between Trade and Investment and the Working Group on the Interrelations between Trade and Competition should draw on each other's work.

Given the breadth of the mandate, a detailed work programme was adopted at the first meeting of the Working Group in June 1997, in the form of a "Checklist of issues suggested for study" ("the list") (WTO, 1997c). The list covers both economic and normative issues and reflects the varying interests of the members of the WTO as well as the complex nature of FDI:

Item I concerns the implications of the relationship between trade and investment for development and economic growth. Among the specific areas suggested for study are the examination of issues such as the effects of investment on transfer of technology, balance-of-payments equilibrium, employment creation and competition.

Item II deals with the economic relationship between trade and investment. It covers *inter alia* the determinants of FDI, the effects of trade policies and trade agreements on investment flows, and the effects of investment policies on trade flows.

Item III concerns existing international arrangements and initiatives on trade and investment. It includes a stocktaking and analysis of existing WTO provisions on investment-related matters; bilateral, regional, plurilateral and multilateral investment agreements other than those covered by the WTO; and the implications for trade and investment flows of existing international instruments.

Item IV deals with issues that are relevant to assessing the need for possible future initiatives and includes the identification of common elements and differences in existing international instruments in the area of investment, the advantages of entering into different types of investment agreements, and the rights and obligations of home and host countries and of investors.

/...

Box III.6 (concluded)

At meetings of the Working Group held in October and December 1997, the Group discussed the first three items on this checklist and, in March and June 1998, identified a number of specific subjects that require further study. It also began discussions on the fourth item.

Further meetings of the Working Group are scheduled to take place in October and November 1998. The Group will probably submit a report to the General Council at the end of 1998, on the basis of which the General Council will decide how the work should proceed.

Source: UNCTAD, based on WTO materials.

Box III.7. UNCTAD's work on a possible multilateral framework on investment

To give effect to the mandate received from UNCTAD IX which called upon UNCTAD to identify and analyse implications for development of issues relevant to a possible multilateral framework on investment (MFI) (UNCTAD, 1996c), UNCTAD has developed a work programme which comprises:

- Substantive support to the intergovernmental process, including the Trade and Development Board; the Commission on Investment, Technology and other Financial Flows, and its expert meetings on MFI-related issues; as well as the WTO Working Group on the Relationship between Trade and Investment (where UNCTAD has observer status). By mid-1998, two expert meetings of the Commission had been held, dealing with existing agreements on investment and their development dimensions: the first meeting (28-30 May 1997) focused on bilateral investment treaties and the second (1-3 April 1998) on regional and multilateral investment agreements.

- Issue papers. Preparation of a series of issue papers addressing key topics related to international investment agreements (on such issues as e.g. national treatment, right of establishment, transfer of technology and restrictive business practices). The main purpose of this series of over 20 papers is to address key concepts and issues relevant to international investment instruments, and to present them in a manner that is useful to policymakers and negotiators. Particular attention is given to the way in which the key topics have been addressed in international investment agreements so far and what their development implications are.

- Regional symposia. Symposia for policymakers in capitals aim at facilitating a better understanding of key issues related to international investment agreements, particularly from a development perspective. The first regional symposium for Africa took place in Fèz, Morocco, in June 1997; the second for Asia took place in July 1998, in New Delhi; further symposia are scheduled to take place during 1998 in Latin America and the Caribbean.

- Geneva-based seminars. Undertaken jointly with the WTO, these are meant to facilitate informal discussions among delegates in Geneva on economic and regulatory investment issues. The first such seminar took place in February 1998; the second in June 1998.

- Dialogues with civil society. The secretariat has invited interested groups from civil society to participate actively in a dialogue with relevant policymakers involved in international investment agreements. The first event of this kind, which took place in December 1997, was a high-level discussion, co-sponsored by UNCTAD and the European Roundtable of Industrialists, between Geneva-based ambassadors and European business leaders; a similar event, co-sponsored with NGOs, took place with a group of NGOs in June 1998; and a third event is planned for the Autumn of 1998 with trade union representatives. A seminar was also organized jointly with the Consumer Unity and Trust Society (CUTS) and the Rajiv Gandhi Institute in New Delhi in July 1998.

- Training activities on FDI for capacity-building purposes. Further training activities on FDI will consist of training courses for junior diplomats and a master class for negotiators.

Source: UNCTAD, 1998e.

- Whatever the fate of these various initiatives, many countries see that it is necessary for them to examine the implications and appropriateness of international investment agreements.

- As discussions and negotiations on FDI advance at various levels, it is also becoming increasingly apparent that agreements on investment, by their very nature, are difficult to negotiate, since they touch, at least in principle, on the entire range of questions relating to production and the production process and therefore involve complex issues of national policy in both developed and developing countries.

- For international investment agreements to be effective and stable, they need to take into account the interest of all parties, to incorporate a balance of interests and to allow for mutual advantage. This applies particularly to developing countries and, more generally, to agreements between countries at different levels of development. In particular, any agreement involving developing countries must incorporate the special dimension of development policies and objectives. Consequently, one of the main challenges ahead is how to ensure that the development objective is given effect and translated into the structure, contents and implementation of international investment agreements (box III.8).

- A more procedural lesson that emerges is that, if broad consensus is to be achieved, it is important that international discussions and negotiations associate, in one way or another, all those potentially affected, including representatives of civil society who have a real stake in the outcome of these processes.

B. Double taxation treaties

The evolution of investment regulations -- which includes adopting less restrictive national laws, concluding BITs and pursuing regional agreements and multilateral discussions on FDI issues -- has also been accompanied by increasing resort to bilateral treaties for the avoidance of double taxation. This section focuses on double taxation treaties, in particular on their role with respect to FDI and the recent trends in their number and distribution.

1. The role and characteristics of double taxation treaties

Reduced obstacles to FDI and the possibilities that they open up for firms to disperse production activities within integrated international production systems create new challenges for tax authorities. Since countries throughout the world are actively competing for the productive growth opportunities that accompany foreign investment, the question of possible double taxation of income from foreign affiliates -- especially those that are an integral part of a firm's globally integrated production and distribution system -- has become increasingly important and complicated (UNCTAD, 1993a, pp. 201-210). Put differently, differences in national taxation norms may entail conflicting interests among all involved (Plasschaert, 1994, p. 3). In the case of a TNC, for instance, both home and host countries

may tax income from foreign affiliates. This situation results from taxation taking into account both the source of income and the residence of the taxpayer, which gives rise to overlapping assertions of jurisdiction and hence to double taxation. More generally, international double taxation is a phenomenon consisting of the concurrent exercise by two or more countries of their taxation rights, a phenomenon generally deemed not to be conducive to business transactions in general and FDI in particular (box III.9).

Box III.8. The development-friendliness of investment agreements

Development is the fundamental objective of developing country governments and of the international community as a whole. How and to what extent this objective can be served by international agreements that address investment issues is a question that is currently attracting considerable attention. If international agreements can, indeed, be helpful in this respect, an important issue is how the concerns of the principal actors in this regard -- host countries, home countries and investors -- can be addressed in a mutually beneficial manner. To a large extent, an investment-friendly environment is also a development-friendly environment. At the same time, it is important to ensure that the developmental needs and concerns of host developing countries are centrally addressed by any investment agreement so that it is development-friendly as well as investment-friendly in its orientation.

Indeed, there are various approaches that might be appropriate, and they are not necessarily mutually exclusive. The ones that are outlined below are intended to be illustrative:

- One approach is to establish a catalogue of development-friendly elements of international investment agreements. Such a catalogue could be a checklist of elements -- without a hierarchy among them -- of issues and concerns that can be consulted when negotiating international investment agreements, be they at the bilateral, regional, plurilateral or multilateral levels. Such a catalogue would be compiled to make sure that, when negotiating agreements, negotiators have indeed considered all relevant issues. Given the congruences, to a large extent, of an investment-friendly environment and a development-friendly environment, such a catalogue would therefore include virtually all issues that need to be considered in the context of investment agreements. A more elaborated version of this approach is to analyse each of these elements in greater detail and to determine how they contribute, singly or collectively, to the development objectives of host countries. Indeed, this kind of analysis may be indispensable because, in practice, it is possible that one element would counteract another.

- A second approach would be to identify a set of development objectives that international investment agreements should serve. Such objectives could include, for example, securing a stable, predictable and transparent investment climate; increasing the quantity and quality of FDI flows; strengthening domestic entrepreneurship; and recognizing the non-discriminatory exercise of governmental regulatory power in pursuing development objectives.

- A third approach begins with the recognition that not only the contents (i.e. specific treaty provisions) of investment agreements need to be development-friendly, but their very structure (i.e. overall design or plan) needs to reflect this objective, as should their implementation (i.e. specific actions by the various parties involved). The challenge is, of course, to spell out in operational detail what "structure" means beyond the statement of objectives and to transcribe it into workable formulations that can be implemented, enforced, monitored and, if disputes arise, adjudicated. On the other hand, when it comes to "content", the catalogue of development -- friendly elements, as well as the development objectives, appears relevant.

UNCTAD's efforts at identifying the development dimensions of international investment agreements draw on ideas, suggestions and feedback from governments as well as other interested parties.

Source: UNCTAD.

The principal response of governments to the challenges of double taxation presented by increased FDI is the extensive and still widening network of bilateral tax treaties which has developed over the past 30 years. There are currently around 1,700 bilateral double taxation conventions in existence (IBFD, 1998).[12] The OECD Draft Taxation Convention/ Model Tax Convention (1963/1977/1992) (OECD, 1997b), and the United Nations Model Double Taxation Convention between Developed and Developing Countries (1980) have provided the framework for the great majority of these bilateral treaties. These models are quite similar, the main difference being that the OECD model favours residence taxation while the United Nations model gives more weight to source taxation (Goldberg, 1983).

The main purpose of international taxation agreements is to deal with tax rights and thus with the allocation of revenues between countries. The contracting countries seek a balanced trade-off between their interests. With respect to developing countries, the challenge as host countries is to find a suitable balance between receiving a share of revenues from foreign affiliates operating in their territory and maintaining a climate that attracts FDI. In this respect, it is generally supposed that, having a smaller share of revenues as a result of tax concessions would in the long run be compensated for by increased inflows of FDI, associated technology and other benefits that are part of the FDI package. For capital exporting countries, as home countries, it is important, on the one hand, to keep their firms internationally competitive by allowing them to benefit from tax concessions in a host country and, on the other hand, to treat all its residents (or taxpayers) equally.

In sum, in examining international taxation with reference to FDI and corporate activity in general, and with respect to developing countries (which are by and large host rather than home countries) in particular, the following broad questions are raised:

- how to divide or share the revenues between host and home countries;
- what kinds of methods to adopt, or which types of measures to take, for the benefit of the host or source country (this is related, among other things, to the definition of "permanent establishment"); and
- what method to use in order to encourage FDI, taking into account the tax benefits,if any, granted in the source country.

From the perspective of investing firms, the binding nature of a tax treaty as an international agreement contributes to a secure basis for FDI; the certainty engendered by the inclusion of rules in a tax treaty is valuable, even in cases where this does not involve a revenue concession, especially where there is a background of unstable domestic tax legislation. By adopting a treaty, a country commits itself in cases of dispute to the objective of avoiding double taxation through a mutual-agreement procedure and adopts an internationally accepted approach to dealing with transfer-pricing issues. Firms and their employees can expect that treaties using the United Nations/OECD model frameworks will be interpreted and applied consistently with the published Commentary on the provisions of the Model Convention (United Nations, 1997). It is generally believed that although, *in form*, the countries conclude a bilateral treaty, *in substance*, by concluding a treaty using an accepted framework, they subscribe to international rules immediately familiar to taxpayers -- rules that promote stability, transparency and certainty of treatment. These features may be at least as important to firms as the particular concessions or incentives that a treaty may contain.

Double taxation treaties generally attribute the exclusive right to tax either to the country where income arises, or to the country of which the taxpayer is a resident. Alternatively, it may attribute this right to both, with an obligation imposed on the country of residence to provide relief for any resulting double taxation. Treaties are aimed not at establishing uniformity of application of taxes but at establishing tax criteria for the prevention of double taxation (Pires, 1989, p. 214).

Typically, a double taxation treaty:

- states its objective of resolving tax problems between contracting parties and determines its scope of application with regard to juridical or physical persons (*ratione personae*) and taxes (*ratione materiae*);

- sets out detailed allocation rules for different categories of income, e.g. income from real property, taxable without restriction in the source country; and interest income, subject to limited taxation in the source country;

Box III.9. Taxation principles

Double taxation can arise in the case of the transnational operations of firms if both host and home countries claim the right to tax firms' revenues. Two main principles underlie the jurisdictional basis of taxation: the first principle is related to the source of income or the site of economic activity (also known as the "territorial principle"); the second is related to the residence (or fiscal domicile) of the earning entity. According to the source principle, a country taxes all income earned from sources within its territorial jurisdiction. Under the residence principle, a country taxes the worldwide income of persons residing within its territorial jurisdiction. Varied criteria are used by countries to determine residence (e.g. for individuals, physical presence or home in a country; for corporations, place of management, head office or incorporation).

Nearly all countries apply some combination of these two jurisdictional principles. Some Latin American countries, however, have traditionally taxed solely on the basis of the source principle. This is also a feature of the tax systems of South Africa and Hong Kong, China.

Apart from these source and residence principles, the criterion of nationality is also applied by a few countries in the case of individuals. This is the case in the Philippines and the United States, whose tax systems combine that principle with the source and residence principles. Under the nationality principle, citizens of the United States, for example, are taxed on their worldwide income no matter where they reside. The United States likewise taxes aliens resident within its territory on their worldwide income and also taxes income derived by non-resident aliens from sources within its territorial jurisdiction. Firms incorporated in the United States, irrespective of the location of their head offices or seats or places of management and control, are taxed on their worldwide income, while foreign corporations are generally taxed solely on income derived from United States sources and effectively connected with a business such a corporation carries on in the United States.

According to some views, taxation only on the basis of the source principle would encourage nationals or residents to invest abroad, thus leading to a flight of capital. It has been argued that countries using only the source principle have adopted it out of necessity because of the great difficulties their tax administrators would encounter if they attempted to find out how much foreign income was accruing to their residents. On the other hand, the residence principle, although based on overall capacity to pay, has proved to be of only limited significance in countries whose residents do not have substantial investments in other countries and whose fiscal administration is not well equipped to ensure its application.

Source: United Nations, 1997.

- establishes the arm's-length principle as the standard for the adjustment of transfer prices by tax authorities in the case of transactions between associated enterprises (box III.10);

- contains rules giving exemption from tax or credit for foreign tax in the residence country, where income is taxable in the source country;

- contains rules on non-discrimination,[13] mutual assistance and the exchange of information;

- establishes procedures for mutual agreement between tax authorities to avoid double taxation in cases of dispute; and

- occasionally contains provisions on assistance in the collection of taxes.

Box III.10. Transfer pricing and double taxation treaties

Transfer prices -- the pricing of goods and services in international intra-firm transactions -- raise complex problems not only for firms engaged in cross-border production, but also for the tax authorities concerned. This is because the allocation of costs and profits between parent firms and foreign affiliates across borders is an area particularly prone to double taxation, and transfer prices determine in large part the income and expenses -- and therefore taxable profits -- of associated firms in different countries. Tax authorities are concerned about the loss of tax revenues and foreign exchange as a result of transfer-price manipulation. On the other hand, the authorities recognize the variety of business circumstances involved and the inherent difficulties of comparing intra-firm and external transactions.

Model conventions and most double taxation treaties contain a description of associated firms with a view to helping countries allocate business income in transactions between associated firms. Treaties give tax authorities the opportunity to make adjustments in the contracting country to which profits are under-reported. They treat each firm, whether parent firm or affiliate, as a separate entity, and the income of each firm is determined by treating it as though it dealt with every other firm at arm's length. The most difficult issue in applying the arm's-length principle is the policing of the prices set by associated firms for transfers of goods, services and intangible property among them. For this purpose, they describe associated firms in terms of common control, management, or capital investment, either between two entities or through a third party. Where the allocation of profits between associated firms located in different contracting countries is distorted as a result of that status, the countries to which an associated firm has underreported profit may impose an adjustment on that firm to accrue the amount underreported. In order to protect against double taxation, most of the treaties provide that, in the event that one contracting country should make an adjustment, the other contracting country should make an appropriate adjustment restoring, as a result, the aggregate profits of the associated firm to its original level.

Double taxation treaties also provide for "multilateral agreement procedures" to discuss their adjustments and correct discrepancies. This mechanism is actually used for resolving any disagreements arising out of the implementation of a treaty in the broader sense of the term. Such a mechanism is a special procedure outside the legal and judicial system of each contracting country and applies in connection with all provisions of the treaty and, in particular, to provisions on associated firms. As a consequence, if an actual allocation is considered by the tax authorities to depart from the arm's-length standard and the taxable profits are redetermined, taxpayers are entitled to invoke the mutual agreement procedure in the framework of which the action by tax authorities can be considered.

Source: Plasschaert, 1994, pp.1-3; United Nations, 1997 and OECD, 1997b.

2. Effects of tax treaties

Tax treaties have their effects through the limitation of the contracting parties' powers to tax. This is done in principle by devising methods for relieving double taxation. In existing treaties, two leading methods are followed for mitigating or eliminating double taxation (Muchlinski, 1995, p. 278). These are the exemption method and the credit method (box III.11). Tax treaties incorporating these methods adopt the following approaches. The source country exempts from taxation (or taxes at a reduced rate) certain categories of income but retains unrestricted taxation rights over other categories. Where the source country taxes at a reduced rate, the residence country gives a credit against its own tax for the tax imposed by the source country. Where the source country taxes without restriction, the residence country will either give a credit against its own tax for the tax imposed by the source country or exempt the income from its own tax.

Box III.11. Methods of relief from international double taxation

In order to avoid double taxation, tax treaties include rules for its alleviation. In this respect, two main methods have commonly been used to mitigate international double taxation.

The first is the tax-exemption method. So far as the income of firms is concerned, exemptions are confined by statute to profits of foreign permanent establishments and income from real property situated abroad. The main reason for the application of this method is that the exemption of foreign-source income from taxation by the country of residence may place the investor in a position of tax equality with residents of the source country, because the tax on that income is determined solely by the level of taxation in the source country. Thus, tax concessions granted by the source country are not reduced or cancelled by the tax of the investor's country of residence. Countries using the exemption method normally do not exempt dividends, interest and royalties from foreign sources from the domestic income tax. Many developed countries, however, grant special relief for domestic intercorporate dividends in order to eliminate or mitigate recurrent corporate taxation, first at the level of a foreign affiliate and then again at the level of the parent company. Some of these countries, either by internal law or by treaty, extend this exemption to dividends paid by a foreign affiliate to a domestic parent.

When this method is applied within the framework of a bilateral tax treaty, one of the parties is granted the exclusive right to tax certain items of income. As in the case of unilateral exemption, the exemption by one party of all or part of an item of income may be integral or may occur with progression. In the case of full exemption, a country of residence might be forbidden to take the exempted item into account in computing its residents' taxable income.

The second method of double taxation relief is the credit method. Countries using this method reduce their normal tax claims on foreign profits by the amount of tax the investor has already paid thereon to the source country. The latter could thus raise its tax rate to the level of the tax of the country of residence without imposing an additional tax burden on the investor. Correspondingly, special tax concessions granted by the source country, which reduce that country's level of tax below the level charged by the country of residence on that income, do not to that extent accrue to the investor's benefit. But this result is limited in its practical scope, since capital-exporting countries consider bona fide foreign affiliates engaged in production activities as being outside their national tax jurisdictions and do not tax their profits until they are repatriated in the form of dividends.

Differences in definitions of taxable income used by host and home country tax authorities may create some difficulties. For instance, the home country authorities may define a corporation's profit obtained in a certain country more narrowly than that country's income tax authorities do, for example, as a result of differences in depreciation allowances or investment credits. The source country's income tax may then be in excess of the tax that the home country would have assessed on that income, which is the upper limit on the tax credit allowed by the home country. Thus, even if the

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The essential feature of the exemption method is that the investor's country of residence exempts from taxation certain items of income from foreign sources. Exemption is mainly granted in respect of active income; passive income such as interest, royalties or dividends is generally taxed, with a credit being given for foreign taxes. The exemption-with-progression method has been used in treaties concluded by Austria, Belgium, Germany, Finland, France, Iceland, Luxembourg, the Netherlands, Spain and Switzerland.

In contrast, the main feature of the credit method is that the investor's country of residence treats the foreign tax, within certain statutory limitations, as if it were a tax paid to itself. Within the framework of a bilateral treaty, each of the contracting parties levies income taxes, but the country of residence permits income taxes paid to the source country to be deducted from its own income taxes, with certain exceptions. The treaty usually indicates which taxes qualify for the credit. A variant of this method (called "matching credit method" or "tax-sparing method") has been developed, according to which the country of residence grants a tax credit calculated at a higher rate than the tax rate currently applied in the source country. Tax-sparing clauses have been included in many bilateral treaties concluded with developing countries by most of the major home countries including Canada, France, Germany, Japan and the United Kingdom. An interesting feature found in recent treaties is reciprocal extension of tax-sparing credit. It is also indicated that the adoption of this method tends to be limited in scope (list of incentives) and in time duration.

(Box III.11, concluded)

host country statutory tax rate is less than the home country rate, it is possible that some part of the host country tax may be disallowed as a credit against home country tax. In the case of dividends in respect of minor (portfolio) holdings in foreign companies, countries applying the credit method normally deduct from their own tax only the foreign tax levied on the dividends as such. However, in order to eliminate or mitigate recurrent corporate taxation, significant capital- exporting countries adopting the credit method allow as a credit against the corporate tax due from the parent company not only the tax levied on dividends by the country where the subsidiary operates, but also the corporate tax paid by the affiliate as far as it relates to profits distributed to the parent company (so-called "indirect tax credit" or "credit for underlying tax").

According to the credit method, the tax burden on investment abroad is the same as that on domestic investment, provided that the tax in the source country does not exceed that in the residence country. This tendency towards equality of tax treatment may have serious implications for developing countries' efforts to attract FDI, since their tax incentives may be nullified. No consequences follow from the use of the credit method while profits from tax incentives are reinvested in the operating subsidiary. However, if such profits are repatriated, the benefit of incentives may pass from foreign investors to the governments of their countries of residence in the form of an increased tax yield.

A method that avoids this problem is the tax-sparing method (referred to as matching credit methods), which can be found in treaties which have been signed by many developed countries, especially European countries, with developing countries. Quite often, the country of residence has granted a credit not only for the tax actually paid in a developing country, but also for the tax spared by incentive legislation in the host country.

There is recent evidence of increasing reluctance on the part of developed countries to adopt the tax-sparing method in their tax treaties. Concerns about the effectiveness of tax incentives and the abuse of tax-sparing provisions have prompted a reconsideration of the use of the tax-sparing method in new treaties and renegotiations of existing treaties.

Source: United Nations, 1980 and 1997; and OECD, 1998b.

It is generally accepted that one of the most important effects of tax treaties is the legal certainty they provide to investors, in both the home and the host countries. Regardless of any changes affecting a host country's tax system, foreign investors cannot be taxed beyond the levels allowed by a treaty. This effect is less comprehensive in the home country. In reality, certain changes in the home country tax system can affect the investor regardless of the existence of a treaty. For example, if the treaty provides for the credit method, a general increase in the corporate tax rate in the home country will also affect a resident deriving foreign-source income, regardless of the treaty. However, the exemption method, if adopted in the treaty, could not be modified at will by the home country.

Tax treaties can have development implications and cannot, therefore, be fully separated from the context of various monetary, fiscal, social and other policies of contracting parties. When the parties are at the same or a similar level of development, the gain or loss of revenue resulting from reciprocal flows of investment does not have the same significance as when the parties are at different stages of development. The presumption of symmetries of gains and losses underlying tax treaties between countries at the same level of development is not applicable for countries at different stages of development. The loss of revenue may have a different "value" for a contracting party, depending on its level of development. For this reason, it could be argued that any eventual reduction in tax revenue from locally produced income should be offset by an increase in investment and technology flows. Since income flows are generally from developing to developed countries, a pattern of tax treaties in which the source country gives up revenue more often than not will not involve the rough symmetry of sacrifice which it might in tax treaties between developed countries. It should also be noted that developing countries, in their domestic laws, often introduce measures aimed at the alleviation of the tax burden of foreign investors, through a variety of tax incentives including income-tax exemptions, reduction or exemption of export proceeds, and reduction or exemptions of individual income taxes for foreign personnel. The benefits of these tax incentives for investors may exceed those resulting from tax treaties. These benefits are, however, offered unilaterally rather than in the context of an international agreement and it may be that foreign investors will value more highly the benefits of more modest reductions or exemptions given in the context of tax treaties with the attendant advantages of stability, transparency and certainty of treatment. From the perspective of host countries, having a smaller share of revenue, as a consequence of concessions offered either in domestic legislation or in the context of a tax treaty, could be (though it need not be) compensated for by increased flows of capital and technology into their economies as the result of an improved climate for FDI.

A number of different views have been expressed on the role that the tax factor plays in attracting or inhibiting FDI (Plasschaert, 1994, pp. 46-47). Although this factor remains subsidiary to other factors, it is also generally accepted that, with the removal of barriers to FDI, taxation may gain more importance in investors' decisions. Long-term investors may attach more importance to the general features of a country's tax system than to its temporary incentives. In considering the role of the tax factor in attracting or inhibiting FDI, it may be important to distinguish the significance of incentives from that of other features of the tax system such as stability, transparency and certainty of treatment. Still, other things being equal, the tax factor could play a determining role in the choice of an FDI location and this in turn could give rise to a tax competition for investment (OECD, 1998b) (box III.12).

Box III.12. Tax competition

The international tax environment is evolving as a result of the removal of capital controls and the continuing liberalization of financial markets, aided by the development of new communication technologies. As obstacles to the flow of capital are reduced, business decisions such as financing and investment have become more sensitive to tax differentials. As a response to these developments, governments of both developed and developing countries have become more inclined to use the tax regime to attract FDI, as evidenced by the rapid spread of preferential tax regimes.

Preferential tax regimes have in common the opening up of profit-shifting possibilities without corresponding shifts in real activities. While these regimes were typically found in tax havens in the past, they have been adopted in recent years by an increasing number of other countries. Once one country introduces such a regime, others may find it necessary to respond with similar measures, thereby triggering a "race to the bottom" in the corporate tax field. This form of tax competition is viewed by an increasing number of countries as harmful because it distorts the flows of capital and reduces the tax base, making investment decisions tax-driven rather than commercially-driven.

Recognizing that these issues can be effectively addressed only through international cooperation, both the European Union and the OECD have recently adopted non-binding instruments for dealing with harmful preferential tax regimes. These instruments, the European Union's Code of Conduct (European Union Council, 13559/97/FIS 167) and the OECD Guidelines (OECD, 1998b), take as a starting point whether a jurisdiction imposes no or low effective taxes in identifying a harmful preferential tax regime. Other criteria considered include whether a regime is "ring-fenced" (i.e. whether it is partly or fully isolated from the economy of the country providing the regime), whether its operation is non-transparent; and whether the jurisdiction operating the regime fails to exchange information with other countries. While the European Union Code and the OECD Guidelines differ in some respects (the main difference being that the OECD Guidelines are limited to financial and other service activities, while the European Union Code covers all types of business activities), the general view is that they are broadly compatible and mutually reinforcing.

Both instruments emphasize the importance of associating non-OECD countries with them. This reflects the concern that, unless the principles behind these instruments are widely accepted, the implementation of these instruments may provoke a displacement of activities to non-OECD countries.

In addition to the Guidelines, the OECD has agreed on a number of recommendations to counter the harmful effects of tax competition. One of these recommendations proposes the development of an OECD tax haven list by October 1999. The objective is to identify and list, on the basis of certain criteria, tax jurisdictions that constitute "tax havens".

Other recommendations are:

Domestic level

- that countries that do not have controlled foreign corporation rules or equivalent rules consider adopting them and that countries that have such rules ensure that they apply in a fashion consistent with the desirability of curbing harmful tax practices;
- that countries that do not have foreign investment fund rules or equivalent rules consider adopting them and that countries that have such rules consider applying them to income and entities covered by practices considered to constitute harmful tax competition;
- that countries that apply the exemption method to eliminate double taxation of foreign source income consider adopting rules that ensure that foreign income that has benefited from tax practices deemed as constituting harmful tax competition does not qualify for the application of the exemption method;
- that countries that do not have rules concerning reporting of international transactions and foreign operations of resident taxpayers consider adopting such rules;
- that countries exchange information obtained under these rules;
- that countries in which administrative decisions concerning the particular position of a taxpayer may be obtained in advance of planned transactions make public the conditions for granting, denying or revoking such decisions; and

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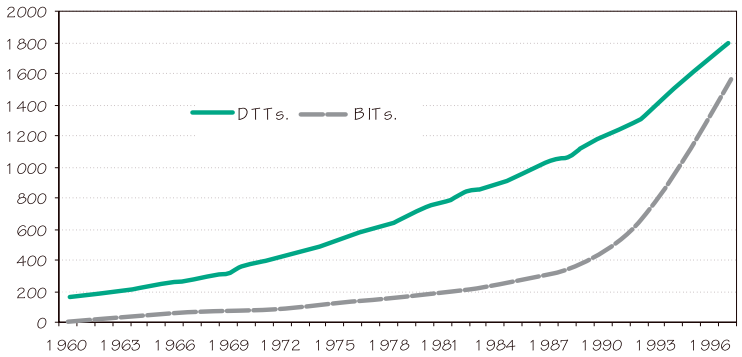
3. The universe of double taxation treaties[14]

The number of double taxation treaties (DTTs) has increased rapidly in the past four decades (figure III.3). By the end of 1997, 1,794 treaties,[15] covering 178 countries and territories, were in existence (figure III.4). This compares with 1,513 BITs involving 169 countries at the end of 1997. Between 1960 and 1997, the rate of increase for DTTs has been steady while the rate of increase for BITs rose sharply in the late 1980s.

Figure III.3. Cumulative number of DTTs and BITs, 1960-1997



Source: UNCTAD, database on BITs and database on DTTs.

Originally, DTTs were concluded mainly between developed countries. Over the years, however, as first the developing countries and then the economies in transition became important host countries for FDI and also emerged as home countries, the universe of tax treaties expanded also to include them (figure III.4). The increased participation of

(Box III.12, concluded)

- that countries, in the context of counteracting harmful tax competition, should review their laws, regulations and practices which govern access to banking information with a view to removing impediments to accessing such information.

Tax treaty level

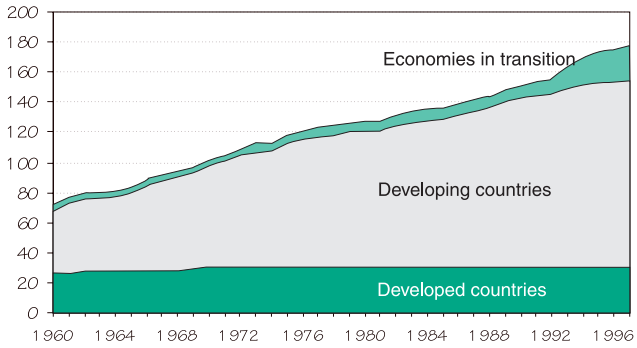
- that countries should undertake programmes to intensify the exchange of relevant information concerning transactions in tax havens and preferential tax regimes constituting harmful tax competition;
- that countries consider including in their tax conventions provisions aimed at restricting the entitlement to treaty benefits for entities and income covered by measures constituting harmful tax practices and consider how the existing provisions of their tax conventions can be applied for the same purpose;
- that countries consider terminating their tax conventions with tax havens and consider not entering into tax treaties with such countries in the future; and
- that countries consider undertaking coordinated enforcement programmes (such as simultaneous examinations, specific exchange-of-information projects or joint training activities) in relation to income or taxpayers benefiting from practices constituting harmful tax competition.

The recommendations also envisage that the OECD Model Tax Convention be modified to include such provisions or clarifications as are needed in respect of the earlier recommendations. To this effect, it is recommended that the Commentary on the Model Tax Convention be clarified to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the Model Tax Convention.

Source: OECD, 1998b.

developing countries and economies in transition has not been limited to concluding agreements with developed countries.[16] Indeed, since the 1980s, DTTs are increasingly being concluded between developing countries and between economies in transition (figure III.5).

Figure III.4. Number of countries and territories with DTTs, 1960-1997



Source: UNCTAD, database on DTTs.

Other salient features of the universe of DTTs are (figures III.3-7):

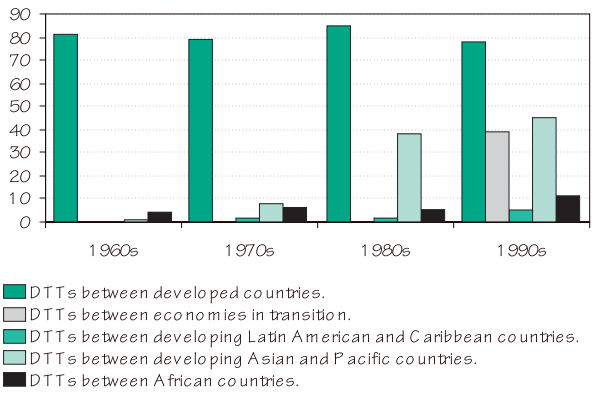
* Whereas the top 10 countries with the highest number of BITs include two developing countries (China and the Republic of Korea) and two economies in transition (Romania and Poland) (UNCTAD, 1998b), *all* of the top ten countries with the highest number of DTTs concluded are developed countries.

* The most prolific countries concluding DTTs in the 1990s have been the economies in transition. The leaders are Poland and Hungary, with 59 and 53 treaties respectively. Of the economies in transition in Central Asia, Kazakhstan led with 17 treaties. The region also has the second highest number of DTTs per country and the third highest number of intraregional DTTs.

* Thirty-five African countries have signed a total of 247 DTTs. Of these, only 26 are with other African countries. The average number of DTTs per country grew rapidly for North Africa in the 1970s and 1980s, most of the growth being attributable to Egypt, Morocco and Tunisia.

* Countries in Asia and the Pacific intensified their DTT activity in the 1980s. During the 1960s they had signed only 29 tax treaties and hence had a very low average number of treaties per country in the region. Since then, 43 countries have signed a total of 560 treaties. Part of the growth in this number includes a substantial increase in the number of DTTs concluded within the region. Not surprisingly, the most active in the region were the East Asian countries.

Figure III.5. Number of intraregional DTTs, by region, 1960-1997



Source: UNCTAD, database on DTTs.

* Latin American and Caribbean countries have signed a total of

218 treaties, but only 9 of these are intraregional. Argentina and Brazil lead the region with 27 and 21 treaties, respectively. This region has one of the lowest number of DTTs per country.

* The United States has signed 154 DTTs, the highest number of any developed country, followed by the United Kingdom with 148 treaties.

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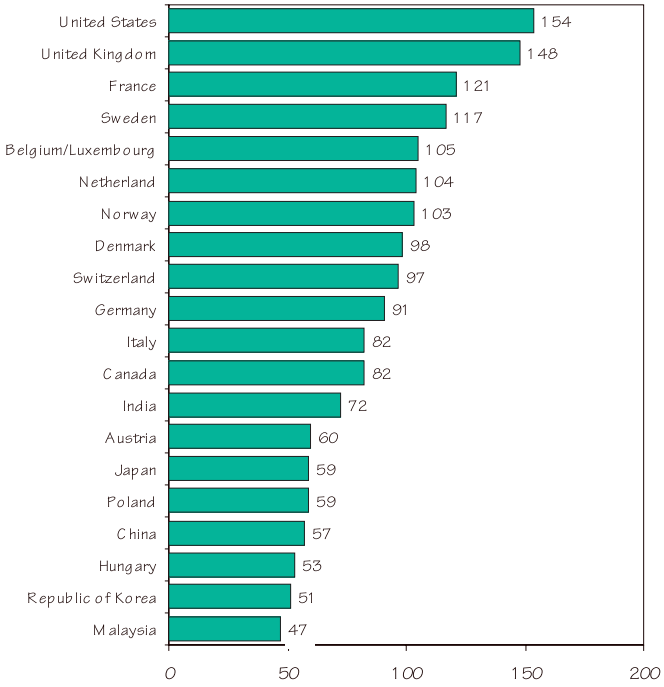
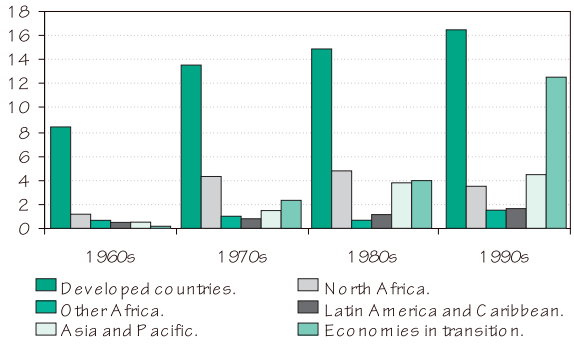
Figure III.6. Number of DTTs concluded: top 20, 1997



Source: UNCTAD, database on DTTs.

If the universe of DTTs is compared with the universe of BITs it needs to be kept in mind that both types of treaties have specific but distinct purposes. The principal purpose of DTTs is to deal with issues arising out of the allocation of revenues between countries; the principal purpose of BITs is to protect the investments that generate these revenues (and they do not deal with tax issues). They are therefore complementary. As developed countries were traditionally the principal home and host countries, DTT issues arose primarily between them, which is why most of the earlier DTTs were between developed countries. As developing countries were seen to involve certain risks for investors, BITs were initially concluded primarily between developed and developing countries; there are no BITs between developed countries. In the early 1960s, developed countries had signed 71 of 72 BITs with a developing country partner, whereas for DTTs the comparable number was 35 per cent. The differences in purpose have also manifested themselves at the country level. Perhaps the most significant observation in this regard is that some countries with a high propensity to sign tax treaties have a low propensity to sign BITs. For example, the United States, by the end of 1996, had signed only 39 BITs, but had signed 154 DTTs. Similarly, India had signed 72 DTTs, but only 14 BITs.

Figure III.7. Average number of DTTs per country, by region and decade, 1960s-1990s

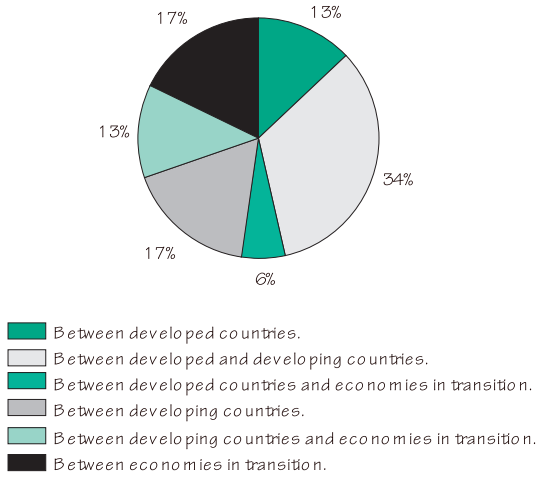


Source: UNCTAD, database on DTTs.

As developing countries became outward investors, and a good part of their investment was in other

developing countries (especially in Asia), they also began to conclude both types of treaties. The regional and intraregional distribution of DTTs compared with that of BITs is, therefore, becoming more similar, with the exception of the number of treaties signed between developed countries (figures III.2 and III.8).

Figure III.8. DTTs concluded in 1997, by country group[a]

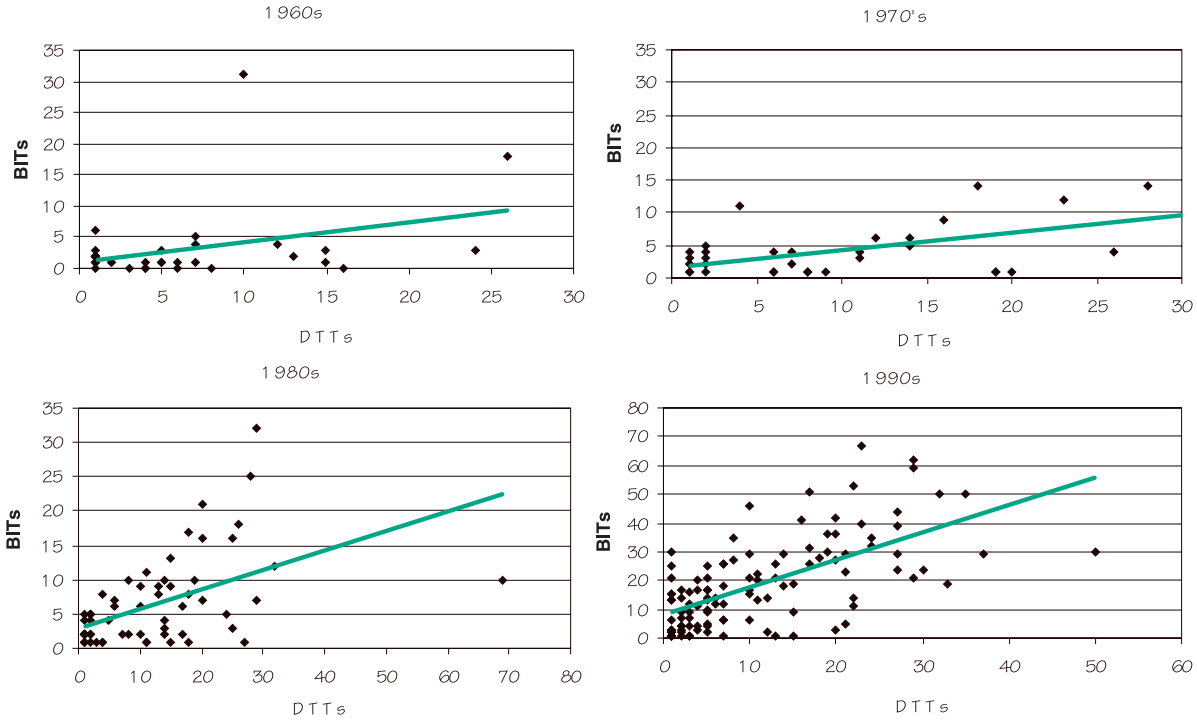


Source: UNCTAD, database on DTTs.

[a] In 1997, 108 DTTs were concluded.

In general there is a positive relationship between the number of tax treaties and BITs signed by countries, a relationship that strengthened significantly in the 1980s and further in the 1990s (figure III.9).[17] Developed countries have almost the same propensity to sign both BITs and tax treaties (921 and 1,222); the same applies to countries from Africa (326 and 272), Asia and the Pacific (684 and 584) and Latin America and the Caribbean (330 and 228). Only the economies in transition have some catching up to do, having signed 770 BITs and only 299 DTTs.

Figure III.9. The correlation between DTTs and BITs signed by countries, by decade, 1960s-1990s



Source: UNCTAD, database on DTTs and BITs.

In sum, the universes of BITs and DTTs, although having started from different points and for different -- but complementary -- purposes, are evolving in the same direction. The propensity to sign both types of treaties has increased -- a reflection of the growing role of FDI in the world economy and the desire of countries to facilitate it.

Notes

1 The absence of a specific FDI law or code does not mean that there are no national laws bearing on FDI, in one way or another.

2 Frequent amendments of laws can cast doubts on the stability of a national legal regime, but the changes in FDI regimes referred to here are mainly in the direction of facilitating and attracting FDI and are thus contributing to improving the countries' investment climate.

3 As the granting of incentives can distort investment flows, their reduction has -- from this perspective -- a similar effect as, for example, a decrease of barriers to FDI.

4 On changes in FDI regimes before 1991, see UNCTC, 1978-1994.

5 According to article 5.1 of the TRIMs Agreement, WTO members, within 90 days of the date of entry into force of the WTO Agreement, shall notify the Council for Trade in Goods of all TRIMs they are applying that are not in conformity with the provisions of the Agreement.

6 "Declaration of Santiago", Santiago, Chile, 19 April 1998, mimeo..

7 Ministerial Declaration of San Jose, 19 March 1998, annex II.

8 "Working Programme for the FTAA Negotiating Groups" (FTAA, TNC/01), p. 5.

9 The joint statement of NGOs arising from that meeting was endorsed by over 600 development, consumer, environment, citizens, human rights and indigenous people organizations (WWF-UK, forthcoming).

10 The position of NGOs with respect to the MAI is reflected, among others, in Clarke, 1998; CI, 1996; CUTS, 1996; European Parliament, 1998; FOE-I, 1998; Korn, 1997; Oxfam, 1998; Public Citizen, 1998; WCC, 1998: WDM, 1997; WGA, 1997; WWF-International, 1996, 1997, 1998a, 1998b; WWF-UK, forthcoming.

11 These efforts build on previous initiatives in the United Nations. Indeed, as early as 1978, the United Nations Economic and Social Council negotiated an "International Agreement on Illicit Payments". In 1979, an almost complete draft of the Agreement was transmitted to the General Assembly which, however, decided to take no action on it (UNCTAD, 1996b, p .103).

12 A broad definition of double taxation treaties (apart from agreements on income and capital) would include bilateral agreements on inheritance, gifts and air or sea transport. These agreements generally contain rules with fiscal implications.

13 The non-discrimination clause is generally understood as a national treatment clause. The clause prohibits a treaty partner from granting to nationals of the other contracting party a treatment more burdensome than that granted to its own nationals, provided the former are in the same situation as the latter or a substantially similar one. It further ensures that none of the contracting parties treats companies in a differentiated way depending on whether their capital is held by its own nationals or by nationals of the other treaty partner. Mention should be made of the long-standing acceptance of the principle of non-discrimination in international fiscal relations. In fact, long before the emergence of the double taxation treaty at the end of the nineteenth century, the principle of non-discrimination in fiscal matters had been embodied in many different types of international agreements under which each contracting party granted nationals of the other contracting party the same treatment as its own nationals (consular or establishment conventions, treaties of friendship or commerce, etc.).

14 The international community has been dealing with the question of double taxation since 1928. For instance, the League of Nations was involved in the elaboration of rules governing the taxation of firms operating in two or more countries. In 1935, a draft convention was prepared.

15 This total includes 26 multilateral treaties, but neither model treaties nor the treaty between France and Quebec.

16 In this analysis, economies in transition include those in Central Asia.

17 A simple regression yields estimated positive coefficients ranging between 0.26 and 0.43, with the highest coefficient for the 1990s. All were significant at the .05 per cent level. There was a jump in the constant term in the regressions that should also be noted. In the 1960s regression it was 1.054, but in the 1980s regression for the 1960s it was 3.133.