International Investment Perspectives

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2004 Edition

OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

– to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;

– to contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and

– to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

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Foreword

Investment is essential to global prosperity and stability. Co-operation and dialogue on policies for improving the investment environment figure prominently in OECD's work. This mission has been entrusted to the OECD Investment Committee – the community of investment policy makers in advanced countries.

The Committee is a forum for mutual learning from experience and developing good policy practices. It builds on long-standing OECD investment instruments – the Codes of Liberalisation and the Declaration on International Investment and Multinational Enterprises – to encourage transparent and non-discriminatory regimes for investment and monitor progress among countries. The Committee adopted recently two new policy implementation tools, a Framework on Investment Policy Transparency which is released in the present issue of the International Investment Perspectives, *and a Checklist on FDI Incentive Policies. The OECD actively shares the use of these tools with non-member economies. One example is an article in the present issue on ASEAN countries' experience with investment incentives.*

The Committee is also responsible for the effective implementation of the OECD Guidelines for Multinational Enterprises, one of the foremost global instruments for corporate responsibility. The present issue reproduces an article by the OECD Secretary-General on emerging trends and recent achievements using the OECD Guidelines.

In recent years, the Investment Committee has engaged in policy dialogue with Brazil, China, Russia and other non-member major players and regional partners for designing effective, broad-based policy frameworks for improving the business environment. One article on Russia in the present issue is an outcome of these activities.

The Investment Committee works with legal experts and treaty negotiators to enhance common understanding of emerging issues relating to international investment treaties and arbitration. Two articles in the present issue on the relationship between investment agreements and most favoured nation treatment attest to this work.

The Investment Committee works with the IMF as joint guardians of international definitions of foreign direct investment (FDI) and collects international investment statistics to assist policy making in member countries. The first article in this publication describes recent trends in FDI on the basis of these statistics.

Note by the Editor

International Investment Perspectives is an annual publication. Each issue includes an update of recent trends and prospects in international direct investment and provides analyses of investment policy questions of topical interest. Articles are based principally on contributions by the OECD Secretariat, which have been developed within the framework of the activity programmes of the OECD Investment Committee.

International Investment Perspectives is published on the responsibility of the Secretary-General and the views expressed therein are not necessarily those of the Organisation for Economic Co-operation and Development and its members. Queries concerning the contents of this publication should be addressed to the Investment Division of the OECD Directorate for Financial and Enterprise Affairs (Hans Christiansen, Editor. Tel.: (33-1) 45 24 88 17; Fax: (33-1) 44 30 61 35; E-mail: *hans.christiansen@oecd.org*).

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Chapter 1

Trends and Recent Developments in Foreign Direct Investment*

Foreign direct investment (FDI) in the OECD continued to fall in 2003. Total inflows were USD 384 billion, down from USD 535 the year before. A reason for this appears to be the sluggish macroeconomic performance of many of the larger OECD economies, not least in Europe. Another factor contributing to the moderate FDI activity in 2003 is that several sectors that saw rampant cross-border investment in the late 1990s and 2000 have entered into a phase of consolidation.

The contraction of FDI in recent years does not imply that FDI activity is low by any longer-term historic standard. OECD area inflows, for example, compare favourably with the early and mid-1990s, even if they are much below the levels recorded in the peak year 2000.

Outflows of direct investment to non-OECD countries has held up well in recent years, and net outflows to developing, emerging and transition economies in 2003 stood at an all time high. China, in particular, positioned itself as the world's foremost destination for FDI.

* This article was prepared by Hans Christiansen and Ayse Bertrand of the Investment Division, OECD. Thanks are due to the OECD Development Co-operation Directorate for statistical inputs into parts of the article.

1. Recent developments

Low growth in Europe and corporate consolidation depress FDI

Foreign direct investment (FDI) in the OECD continued to fall in 2003. One reason for this appears to be the sluggish macroeconomic performance of many of the larger OECD economies, not least in Europe. This would appear to have depressed outward as well as inward investment. Companies operating in economies with poor macroeconomic performance are less attractive to outside investors, and may at the same time – at least insofar as their profitability is affected – scale back their outward investment as well.

A further reason for the moderate FDI activity in 2003 is that several sectors that saw rampant cross-border investment in the late 1990s and 2000 have entered into a phase of consolidation. Enterprises tend to be disinclined to embark on new purchases while still in the process of integrating foreign acquisitions of recent years into their corporate strategies. This caution may be further strengthened by the fact that, in certain sectors, (notably the "new economy" activities) investors would seem to have paid excessively for some of their acquisitions. Finally, companies who have acquired corporate "prized assets" in other countries have in some cases progressed to sell off some of the non-core activities of their acquisitions. Insofar as they sell these corporate assets to domestic investors in the host economy, such disinvestment weighs down on the overall inward FDI figures.

All the same, the contraction of FDI in recent years does not imply that FDI activity is low by any longer-term historic standard. OECD area inflows, for example, compare favourably with the early and mid-1990s, even if they are much below the levels recorded in the peak year 2000.

1.1. Further declines in most OECD countries' FDI

Inward FDI dropped by 28 per cent in 2003

FDI to and from the OECD countries continued to decline in 2003. FDI into the OECD area dropped from 535 billion US dollars (USD) in 2002 to an estimated USD 384 billion in 2003 (Table 1.1) – a decline of around 28 per cent. The figure is consistent with projections in last year's *International Investment*

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Table 1.1. **Direct investment flows to and from OECD countries: 2000-03**
USD billion

	Outflows				Inflows			
	2000	2001	2002p	2003e	2000	2001	2002p	2003e
Australia	0.7	12.2	7.6	14.3	13.2	4.7	16.5	7.8
Austria	5.7	3.1	5.3	7.1	8.8	5.9	1.0	6.9
Belgium/Luxembourg	218.4	100.6	. .	. .	221.0	84.7	. .	. .
Belgium	. .	. .	11.0	39.0	. .	. .	13.1	31.3
Luxembourg	. .	. .	126.2	81.8	. .	. .	117.1	73.2
Canada	44.7	36.1	26.4	21.6	66.8	27.5	21.0	6.6
Czech Republic	0.0	0.2	0.2	0.2	5.0	5.6	8.5	2.6
Denmark	26.5	13.4	5.7	1.2	33.8	11.5	6.6	2.6
Finland	24.0	8.4	7.6	–7.4	8.8	3.7	7.9	2.8
France	177.5	86.8	49.5	57.3	43.3	50.5	48.9	47.0
Germany	56.6	36.9	8.6	2.6	198.3	21.1	36.0	12.9
Greece	2.1	0.6	0.7	0.0	1.1	1.6	0.1	0.7
Hungary	0.6	0.4	0.3	1.6	2.8	3.9	2.8	2.5
Iceland	0.4	0.3	0.2	0.2	0.2	0.2	0.1	0.1
Ireland	4.6	4.1	3.1	1.9	25.8	9.7	24.4	25.5
Italy	12.3	21.5	17.1	9.1	13.4	14.9	14.6	17.0
Japan	31.5	38.4	32.3	28.8	8.3	6.2	9.2	6.3
Korea	5.0	2.4	2.6	3.4	9.3	3.5	2.4	3.2
Mexico	. .	4.4	1.0	. .	16.4	26.6	14.4	10.7
Netherlands	75.6	48.0	34.6	36.1	63.9	51.9	25.6	19.7
New Zealand	0.6	0.9	–1.0	–0.1	1.3	4.2	–0.6	0.8
Norway	7.6	–1.3	4.2	2.6	6.9	2.0	0.7	2.2
Poland	0.0	–0.1	0.2	0.4	9.3	5.7	4.1	4.2
Portugal	7.5	7.6	3.3	0.1	6.8	5.9	1.8	1.0
Slovak Republic	0.0	0.1	0.0	0.0	2.4	1.6	4.1	0.6
Spain	54.7	33.1	31.5	23.4	37.5	28.0	35.9	25.6
Sweden	40.7	6.4	10.7	10.6	23.2	11.9	11.6	3.4
Switzerland	44.7	18.2	7.6	10.9	19.3	8.9	5.7	12.2
Turkey	0.9	0.5	0.2	0.5	1.0	3.3	1.0	0.6
United Kingdom	233.5	58.9	35.2	55.3	118.8	52.7	27.8	14.6
United States	159.2	120.0	134.8	173.8	321.3	167.0	72.4	39.9
Total OECD	**1 235.8**	**661.9**	**566.7**	**576.3**	**1 288.0**	**624.9**	**535.0**	**384.4**

Note: Data are converted to US dollars using average exchange rates.
p Preliminary.
e Estimate.
Source: OECD International Direct Investment Database.

Perspectives, which, based on mergers and acquisitions data for the first half of the year, predicted that 2003 FDI inflows could drop by another 25-30 per cent. This moreover indicates that, contrary to the expectations of many at the time, there was no significant pick-up in activity in the second half of 2003.

FDI outflows remained broadly unchanged. In 2003, they stood at USD 576 billion, compared with USD 567 the year before, or an increase of less than 2 per cent.

OECD countries' traditional role as net providers of direct investment to the rest of the world was greatly strengthened. Net FDI flows to non-member economies reached an impressive USD 192 billion, up from USD 32 billion in 2002 and USD 52 billion in 2001.

North America was particularly affected

The fall in FDI inflows affected all major regions, but nowhere more than North America. US inflows of direct investment in 2003 were USD 40 billion – down from USD 72 billion in 2002, or a decline of 45 per cent. This partly reflects an upward revision of the 2002 data. In consequence, 2003 became the first year on record (not 2002 as previously announced) in which China surpassed the United States as the world's foremost recipient of FDI.[1] Canada, on the other hand, saw its inflows of FDI drop by USD 15 billion (or about 70 per cent), as US investors reportedly set sight on further-away investment locations. Japan, not a major host country for direct investment, saw its inflows drop by about a third in 2003 from a level that was already internationally unremarkable.

A mixed pattern in Europe

The 2003 FDI inflows to European countries were 23 per cent lower than in 2002 (the decline in EU and the Euro-zone were of a comparable magnitude). This figure covers very considerable trend differences between individual countries. On the whole, most European nations saw larger-than-average declines, the effect of which on the overall figures was cushioned by the resilience of FDI in a few relatively large economies. Some stylised observations offer themselves:

- Some of the largest relative declines in FDI inflows were seen in Central Europe. FDI into Slovak and Czech Republics dropped by 85 and 70 per cent, owing in part to the one-off effect of large investment projects in 2002 (in the automotive and energy sector, respectively).
- Direct investment flows into Germany fell by 64 per cent, and by the same token recorded the second-largest absolute decline in 2003. FDI inflows were down by USD 23 billion from 2002.
- Other large declines were seen in the Nordic countries. FDI flows into Sweden and Finland fell by around two thirds in 2003, *inter alia* reflecting

the effect of changed ownership structures within the Nordic region's largest commercial bank.

- The FDI flows into the United Kingdom fell almost by half in 2003, from a level that was already unimpressive by historical standards.
- Among the countries whose inward FDI has held up France stands out by the sheer volume of investment that the country continues to attract. In 2003, inflows to France were USD 47 billion, only marginally beneath inflows of 2002 and at three times the levels recorded in Germany and the United Kingdom. The acquisition of real estate by foreign investors has reportedly been an important factor.
- The figures indicate that Spain holds up very well, both as an inward and an outward direct investor. However, some caution is called for. The expansion of foreign securities holding companies (ETVE by their Spanish name) is believed to have boosted gross FDI flows from and to Spain.[2]
- Some of the smaller European countries recorded sharp increases in inward FDI in 2003, in most cases reflecting the effect of particularly low investment the year before. Examples include Switzerland, Austria and Norway, all of whom saw their inflows more than double.

Taking a slightly longer perspective, the average OECD economy has seen its FDI inflows drop by 70 per cent since the peak in 2000. The largest relative declines over the period among the larger countries were recorded by Germany (94 per cent), strongly influenced by a major cross-border acquisition in the telecom sector in 2000, and the United States and United Kingdom (87 per cent, respectively). The particularly large, and similarly sized, declines in these two large economies is illustrative of the fact that a considerable part of the strong activity in the late 1990s and 2000 was ascribed to a flurry of cross-border takeovers between them.

Increasing net outflows to poorer countries

The largest suppliers of FDI to other countries were, in order of importance (disregarding Luxembourg – see footnote 1) United States, France, United Kingdom, Belgium, Netherlands and Japan. US enterprises are by far the world's most active outward direct investors, with USD 174 billion recorded outflows in 2003. On the whole, US outflows have held up surprisingly well during the years after the burst of what may have been an investment bubble in 1999-2000. Outward investment from the United States at no point in time dropped below USD 120 billion – even as other traditional investor countries saw their outflows plummet. Consequently, in what amounts to a sharp reversal of the trends during the "dot-com boom", the United States has become a net provider of direct investment to the rest of the world.

Over the last decade, the role of OECD countries as the world's foremost provider of direct investment funds has been firmly established (see also the following Section 3). New outflows from the OECD area reached USD 879 billion over the last decade (1994 to 2003 – see Table 1.2). The United Kingdom, France, Japan, Switzerland and the Netherlands have been the OECD's main net exporters of FDI. By contrast the United States – which is by fare the top country both as an investor and a recipient of FDI – is close to breaking even between inflows and outflows, and has actually been a net recipient over the last ten years.

Table 1.2. **Cumulative FDI flows in OECD countries 1994-2003**
USD billion

Inflows		Outflows		Net outflows	
United States	1 349.6	United States	1 331.0	United Kingdom	415.6
Belgium/Luxembourg	762.7	United Kingdom	878.6	France	301.0
United Kingdom	463.1	Belgium/Luxembourg	767.0	Japan	217.6
Germany	387.0	France	652.7	Switzerland	108.5
France	351.6	Germany	452.7	Netherlands	96.3
Netherlands	286.5	Netherlands	382.8	Germany	65.6
Canada	208.1	Japan	268.0	Spain	46.7
Spain	183.5	Canada	237.3	Canada	29.2
Sweden	168.2	Spain	230.1	Finland	26.7
Mexico	138.2	Switzerland	190.4	Italy	25.9
Ireland	120.0	Sweden	150.2	Belgium/Luxembourg	4.3
Denmark	91.7	Italy	112.4	Portugal	3.4
Italy	86.5	Denmark	82.0	Norway	2.2
Australia	82.2	Finland	72.6	Iceland	0.5
Switzerland	81.9	Australia	57.3	Korea	–3.4
Poland	52.0	Norway	37.7	Greece	–5.0
Japan	50.5	Korea	37.5	Turkey	–7.0
Finland	45.9	Austria	33.6	Austria	–7.6
Austria	41.2	Portugal	29.2	Denmark	–9.7
Korea	40.9	Ireland	26.7	Slovak Republic	–10.9
Czech Republic	37.9	Mexico[1]	5.4	New Zealand	–17.0
Norway	35.5	Hungary	3.9	Sweden	–18.0
Hungary	32.4	Greece	3.7	United States	–18.7
Portugal	25.7	Turkey	3.6	Australia	–24.8
New Zealand	19.9	New Zealand	2.9	Hungary	–28.4
Slovak Republic	11.0	Iceland	1.5	Czech Republic	–36.7
Turkey	10.6	Czech Republic	1.2	Poland	–50.9
Greece	8.7	Poland	1.1	Ireland	–93.3
Iceland	1.0	Slovak Republic	0.1	Mexico[1]	–132.9
Total OECD	**5 174.0**	**Total OECD**	**6 053.1**	**Total OECD**	**879.2**

1. Based on outflow data for 2001 and 2002 only.
Source: OECD International Direct Investment Database.

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1.2. Strong activity among some non-members

Investors in developing countries go for big markets

Taken as a whole, non-OECD countries' FDI inflows have held up better in recent years than those in the OECD area. On the one hand, this is hardly surprising given that the build up to the 2000 investment peak also affected OECD countries disproportionately. On the other hand, the nature of FDI to developing countries does appear to have changed somewhat over the last decade. In the past, it was often assumed that multinational enterprises invest in developing countries in order to gain access to resources or to integrate low-wage locations into their global value chains. However, there has been an increasing tendency for companies to invest in especially the largest developing countries as part of strategies to service local clients or to acquire a strategic position in markets that could become prosperous in the future. This trend was further underpinned by the privatisation programmes of many high- and medium-income developing countries in the 1990s, whereby national utilities were transferred into the hands of private strategic investors.

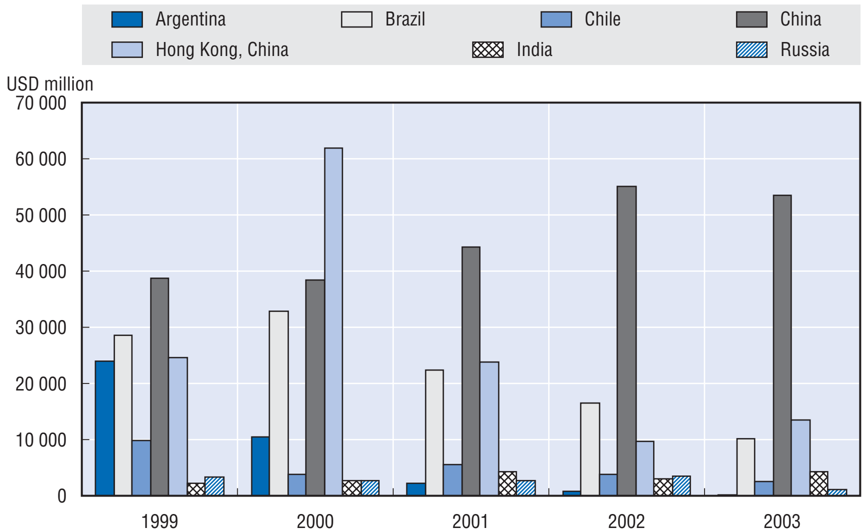
China is a case in point

The entry of market-seeking investors is felt nowhere stronger than in mainland China, which has experienced nothing of the trend-decline in investment seen virtually everywhere else since 2000. Following 2002, inward direct investment receded slightly in 2003 (Figure 1.1). With total inflows topping USD 53 billion, China nevertheless was the world's largest or second-largest recipient of FDI.[3] Inward investment into Hong Kong (China) further boosted inflows to the overall Chinese economy by USD 13 billion in 2003. However, this figure must be interpreted with caution. It is thought to be influenced by Chinese businesses' use of companies registered in Hong Kong (China) for investment in the mainland.

Other big countries have great potential

The world's second-largest country, India, is nowhere near rivalling China's success with attracting investment, but it has made considerable progress over the last decade. Owing chiefly to a policy change to allow foreign investment into a growing number of sectors, inward FDI rose from almost zero in the 1990s, and annual inflows have been consistently above USD 2 billion since 1995. The 2003 inflows, at USD 4 billion, were only a fraction beneath the peak year 2001.

Figure 1.1. **FDI inflows to developing and other countries**



Source: IMF International Financial Statistics and national sources.

FDI inflows to Russia, at just over USD 1 billion in 2003, reached its lowest level since the mid-1990s. This is indicative of a long-standing feature of Russian inward investment: it mainly flows into the resource-based sectors – plus a few service-related sectors such as retail and distribution in the larger cities. The Russian investment landscape is the topic of another article in the present issue of *International Investment Perspectives*.

South America is affected by the Argentine crisis

Direct investment into South America has been influenced by two main factors in recent years, namely a slowdown in investor interest similar to what was seen in the OECD area and the fallout from the Argentinean crisis. Unsurprisingly, the inflows to Argentina itself have virtually dried up. From an internationally high USD 24 billion in 1999 they have declined to just USD 230 million in 2003. From 2000 to 2003 the decline was 90 per cent. On the other hand, Brazil has been less affected that might have been expected. FDI inflows have been cut by half since their peak in 2000, which compares favourably with an average OECD decline in inward FDI of around two thirds.

Chile presents another interesting case. With a decline in direct investment inflows of two thirds since the peak levels in 1999/2000 (measured relative to an average of the two years, as 2000 figures were relatively low), this country's FDI performance is worse than Brazil's, but comparable with that of

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an average OECD country. Some observers have opined that Chile may have reached what is sometimes termed "investment maturity", meaning that not only is it beginning to mark itself as an important outward investor, but foreign-owned entities in the Chilean economy are increasingly operating like national enterprises, seeking their business partners and (importantly in the FDI context) finance locally. With inward investment positions already very high relative to the size of the economy, and with the national privatisation process having run its course, the challenge for Chile will be broadening its appeal to foreign investors beyond its traditional host sectors.

Challenges in the Middle East

An area with an apparently great potential, but little success so far, for attracting investors is the Middle East and North Africa (MENA) region. Partly as a result of an enhanced, but limited, openness to foreign investment, FDI has increased in recent years, but not as rapidly as in some other developing regions. Net FDI inflows in those MENA countries for which relevant figures are available grew to USD 7.4 billion in 1998, but subsequently fell to only USD 2 billion in 2003, while in the latter year all other developing world regions received far more FDI.[4]

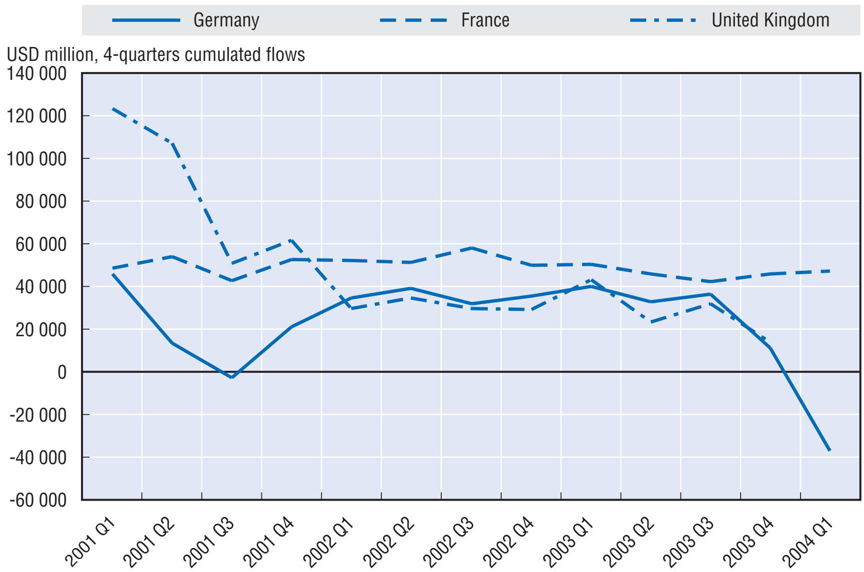
FDI inflows per capita in MENA countries in the period 1998-2000 averaged USD 21 per year, far lower than the comparable figure of USD 1 321 for OECD countries in 2000.[5] During this time a wide variation was displayed between MENA countries, where FDI inflows ranged from USD 0.2 per year per capita in Algeria to USD 155 in Saudi Arabia, with Yemen experiencing an outflow averaging USD 12. Also measured relative to the size of the domestic economies, FDI inflows have played a relatively modest role in MENA countries. In 1998-2000 the average MENA FDI-to-GDP ratio was only 0.9 per cent – the same as for Sub-Saharan African countries, and markedly below the 3 per cent recorded in Latin America and East Asia.

1.3. Prospects for the future

The short-term prospects appear sedate

Relatively little information is available at this point in time about FDI trends in the first quarter of 2004, and whatever is available must be interpreted with extreme caution, as quarterly investment figures for individual countries are notoriously volatile. That said, an analysis of recent quarterly trends for the OECD area as a whole yields valuable additional insights.[6] First and foremost, the inward FDI to OECD countries appear to have slowed down throughout 2003. In the fourth quarter of 2003 they stood at USD 75 billion, the lowest quarterly

Figure 1.2. **Quarterly foreign direct investment inflows**



Source: OECD Main Economic Indicators Database.

figure registered so far in the 21st century. This runs counter to the assumption by some that, while FDI in 2003 may have been relatively low, there were indications of a turnaround in the course of the year.

Secondly, in some countries there are recent signs of considerable disinvestment by foreign enterprises. Figure 1.2 shows quarterly trends (smoothed by means of 4-quarter revolving sums) for the largest European economies. In the case of Germany, inward investment in both 2003:Q4 and 2004:Q1 went sharply negative. Preliminary figures indicate a gross outflow of more than USD 30 billion in the first quarter of 2004, as inward investors of the past withdrew funds. Among the other observations that can be made from Figure 1.2, the United Kingdom's inward FDI remained on a slight downward trend in 2003 (no 2004 figures are yet available), whereby the remarkable resilience of inward French FDI appears to have continued into 2004.

A pick-up is expected in the longer term

Whereas the near-term outlook for FDI may not be particularly encouraging, there are indications that FDI could trend upwards over the slightly longer term. Macroeconomic forecasts, including by the OECD, point to a cyclical recovery in the main OECD countries and an enhanced corporate profitability over the next couple of years. Another key driver of FDI, equity market valuation, has already risen considerably. Hence, one the ongoing structural adjustment in many countries has run its course the outlook is for a renewed strengthening of cross-border mergers and acquisitions and other kinds of direct investment.

Some have argued that the longer-term outlook is clouded by public concerns about cross-border investment. Within the European Union, a factor that could discourage high profile projects in particular is a perceptible change in attitudes toward FDI. The introduction of the euro was widely expected to trigger Europe-wide consolidation in many sectors and attract outside investors keen to establish themselves is an ever-more integrated European markets. A few years back this prospect was hailed, or accepted, by policy makers. However, hesitations to contemplate the takeover of large national enterprises by foreign competitors, including cross-border consolidation within the EU, have been apparent in some countries. It is, admittedly, unlikely that a large number of cross-border acquisitions will be hampered by such considerations, but large enterprises could nevertheless decide to apply a more cautious strategy toward cross-border investment within the EU area.

Present public concerns about FDI are not helpful

Another factor that could weigh down on FDI is a discussion about corporate outsourcing that has been resurfacing in some of the OECD's largest member countries. Amid sizeable job losses in the industrial sectors it is unsurprising that societies quiz the location strategies of their biggest enterprises. However, a process of relocating low-skilled production processes, whether in the context of direct investment or otherwise, from high to low wage countries has been ongoing since the early days of industrialisation, and it has contributed greatly to the welfare of both home and host countries.

On the whole, however, most observers expect direct international investment to increase over the medium term. For example, a recent survey of investor intentions released by UNCTAD found that more than 70 per cent of the largest multinational enterprises expect FDI to increase from present levels over the next three years.[7] The expectations to an increase in direct investment are unequally distributed among host countries. On the whole, developing and transition countries appear to figure more prominently in companies' investment plans than the large OECD economies. The survey indicates that the regions that are expected to benefit the most from about stronger direct investment are Central and Eastern Europe and the Asian countries. Within the first category, OECD member Poland figures prominently, as does the Russian Federation. Within Asia, enterprises expect

China to receive (even) higher FDI flows than today, and they foresee a pickup in direct investment into India and Thailand.

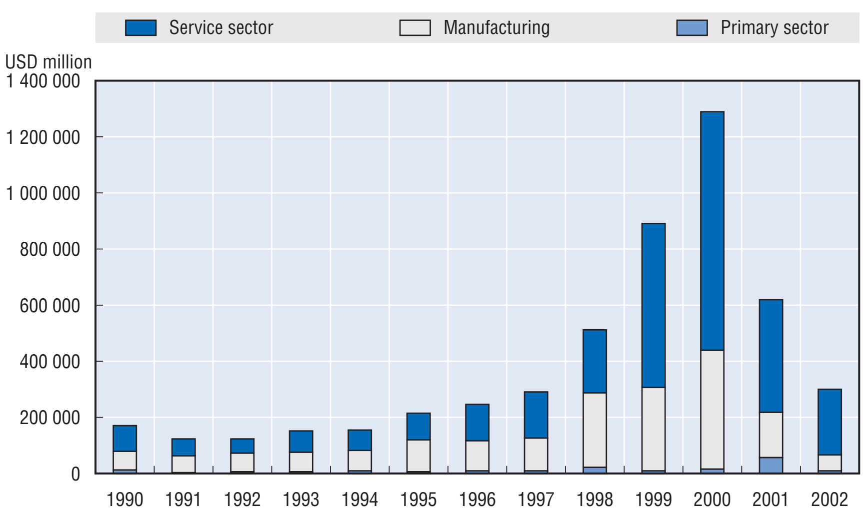
2. Changing sectoral patterns: services to the fore

Changing sectoral distribution of FDI

The sectoral distribution of FDI has changed markedly in recent years. Traditionally, the manufacturing industries have accounted for at least half of annual FDI inflows to OECD countries, with the service sectors (defined broadly to include construction and utilities) recording a slightly lower share, and the primary sectors rarely receiving more then 5 per cent of total flows. During the investment boom of the late 1990s and 2000 the service sectors saw their share increase to two thirds of total OECD inflows (Figure 1.3). At the time, this was attributed to the fact that many of the "new economy" and other high-tech activities that were in favour with investors were found in the service sectors. However, as the equity price bubble burst and cross-border investment cooled down, the service sector's share in FDI rose even further. In 2002, services accounted for more than 75 per cent of FDI inflows in the OECD area.

It is hardly possible to draw firm inferences about the future role of the service sectors in FDI, but one may speculate that we have witnessed a level-shift, following which services are likely to be the dominant element of FDI. Historically, direct investment has been considered as linked with manufacturing, plus certain industry-related services, because it was seen as

Figure 1.3. **Total OECD area FDI inflows, by main sector**



Source: OECD International Direct Investment Database.

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motivated principally by the availability of resources abroad and by a wish to internationalise companies' value chains in order to benefit from lower costs (principally labour) in other countries. As services are mostly consumed locally, this has in the past to some extent precluded the service sectors from playing a dominant role in FDI.

The service sectors have gained prominence

However, the nature of FDI is changing, and so are the service sectors. Privatisation in many countries has transformed previous public-sector activities into commercial services and an increasing number of industrial companies are contracting business services from external vendors in preference to providing them in-house. In other words, an average industrial company's value chain involves a larger number of service companies than before. This development has been greatly facilitated by the advent of multimedia technologies such as the internet, which for instance has allowed a large number of companies contract services such as call centres, software development and financial services from providers located in faraway locations.

The motivation and corporate strategies behind FDI may also have shifted. Surveys of investor intentions indicate that an increasing number of investment projects over the last decade were motivated, at least in part, by a wish to sell to the host country market and produce locally. Such a paradigm shift, if it has indeed taken place, works in favour of the services sectors whose product palette is comparatively easy to produce by means of local inputs.

2.1. Differences between countries

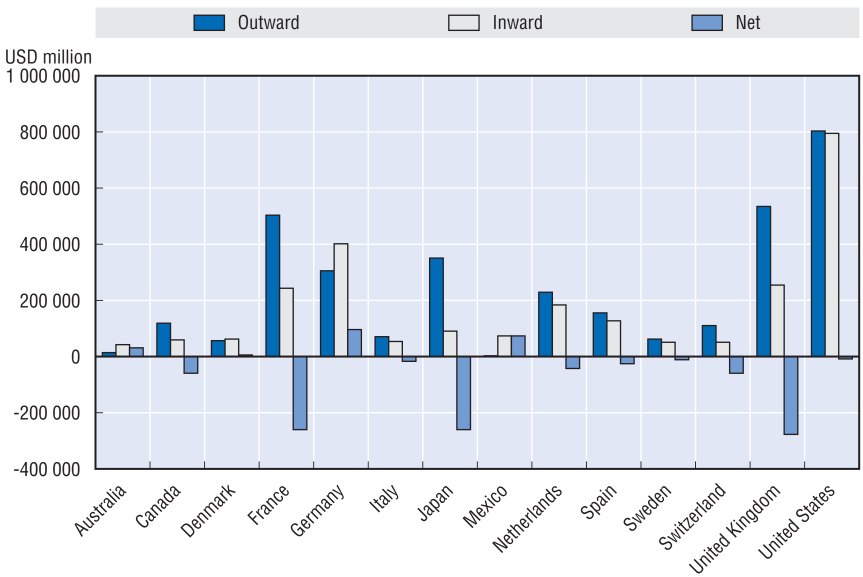
The main recipients of FDI into their service sector are generally the countries that figure prominently in FDI flows overall.[8] The United States received close to USD 800 billion worth of service sector FDI between 1990 and 2002, followed by Germany (USD 400 billion), United Kingdom (USD 250 billion) and France (USD 240 billion). Germany's prominent position does to some extent reflect a couple of very large individual cross-border mergers and acquisitions into the county in the late 1990s.

Over the years, the OECD economies have been a major net provider of direct investment to the service sectors in the rest of the world. One the one hand, this is hardly surprising; as regards FDI in general, OECD has always been a major capital exporter. From 1990 to 2002, net overall outflows to the rest of the world exceeded one trillion US dollars. On the other hand, the prominence of the service sector in this amount is striking: no less than three fourths of all the net outflows during this period were due to service sector investment.[9]

Net flows of service FDI mostly stem from three countries

The vast majority of the service sector net outflows are due to three countries, namely the United Kingdom, Japan and France (Figure 1.4). Each of these countries saw net outflows between 1990 and 2002 in excess of USD 2 000 billion. Conversely, while the United States recorded easily the largest gross flows over the last 13 years, inflows and outflows almost entirely netted each other out. Other countries whose service sectors acted as net exporters of FDI include Canada, the Netherlands and Switzerland.

Figure 1.4. **Service sector FDI in selected OECD countries, 1990-2002**



Source: OECD International Direct Investment Database.

2.2. "New" versus "old" services

Changing distribution within the service sector

The dominant share of service-related FDI has traditionally flowed into "old" service sectors such as trade (including retail and whole sale distribution) and financial intermediation. In the first half of the 1990s, these two sectors generally accounted for two thirds of service sector FDI in the OECD area (Table 1.3). By 2002, these sectors' share had fallen to one third, and the largest recipient of FDI had become the business services sector. Also, the transport

Table 1.3. **Distribution of FDI inflows to the service sector, OECD totals**

Percentage shares to total service sector inflows

	1990	1995	2000	2002
Trade	22.1	19.0	11.2	9.3
Transport and communication	0.9	4.1	12.6	15.7
Financial intermediation	44.6	37.8	37.1	25.7
Business services	3.5	20.0	31.3	31.7
Other services	28.9	19.1	7.7	17.5

Source: OECD International Direct Investment Database.

and communication sectors, bolstered by privatisation, mobile telephony and the advent of multimedia technology have risen from near-obscurity to receive almost 16 per cent of the service sectors' FDI flows in 2002.

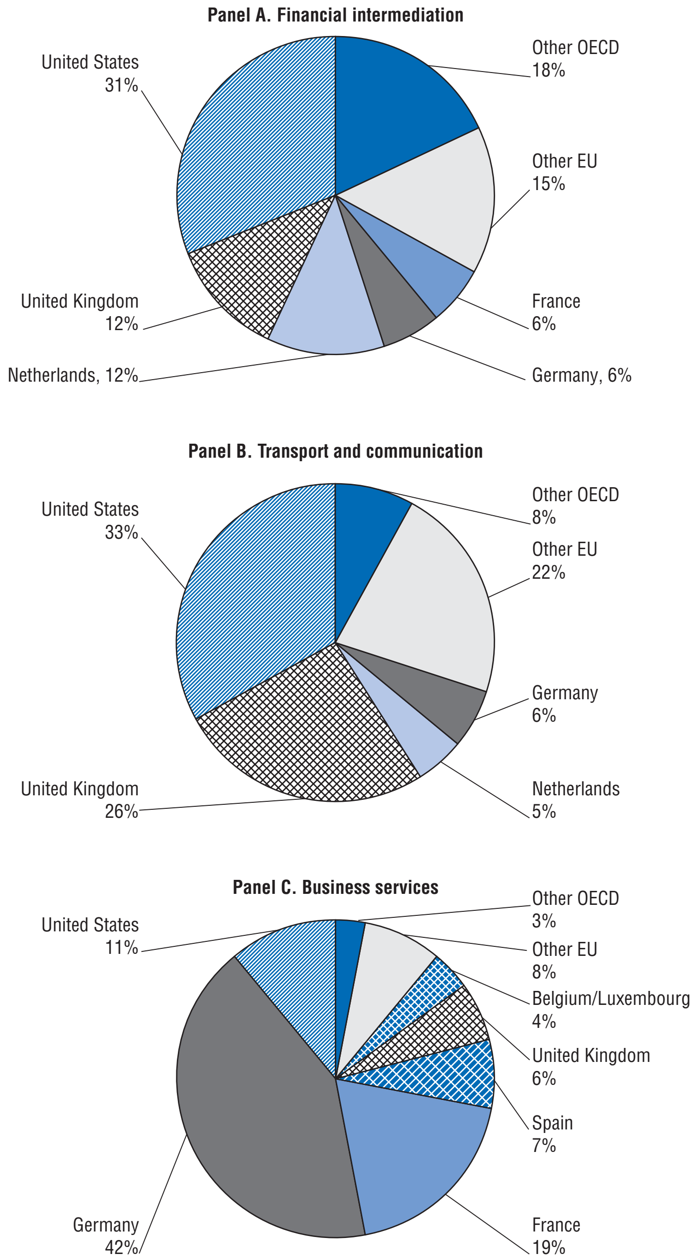
Telecom and "new economy" have gained prominence

The country distribution of FDI inflows differ strongly across the various service market segments. In the "old" sectors the distribution is generally more equal than in those that witnessed rapid growth in the late 1990s. On case in point is financial intermediation. The two countries that host the perhaps most important financial centres, United States and United Kingdom unsurprisingly received the largest shares of total inward FDI in this sector over the last decade, but continental European countries also figured prominently (Figure 1.5, Panel A). In the case of the Netherlands, the figures are however influenced by the fact that many companies, for legal reasons, prefer to establish holding companies and special purpose entities, which are classified as being "financial" in this country.

The UK and US dominance as recipients of FDI in the transport and communication sector since 1990 has been must stronger. The two countries attracted almost 60 per cent of the OECD area's total direct investment in this sector (Figure 1.5, Panel B). This reflects the long-standing predominance of transatlantic mergers and acquisitions (M&As) between the English-speaking countries in areas such as telecommunication. Germany and Netherlands also emerged as important recipients of such FDI, mainly originating from other EU countries.

In the area of business services Germany stands out as by far the largest recipient of FDI in the OECD between 1990 and 2002 (Figure 1.5, Panel C). To a large extent this reflects a few very large cross-border take-overs into Germany. Foremost among these was the Vodafone-Mannesmann purchase (the world's largest cross-border M&A so far) which, while the strategic

Figure 1.5. **Inward FDI in different sectors, 1990-2002**



Source: OECD International Direct Investment Database.

motivation was a linkup of the two companies' mobile telephony business counted as business service FDI because Mannesmann was categorised as an engineering service company. Other European countries, notably France, also figured prominently in this sector, whereas the United States received a comparatively limited 11 per cent of total inflows.

3. FDI in non-OECD countries: a source of development finance

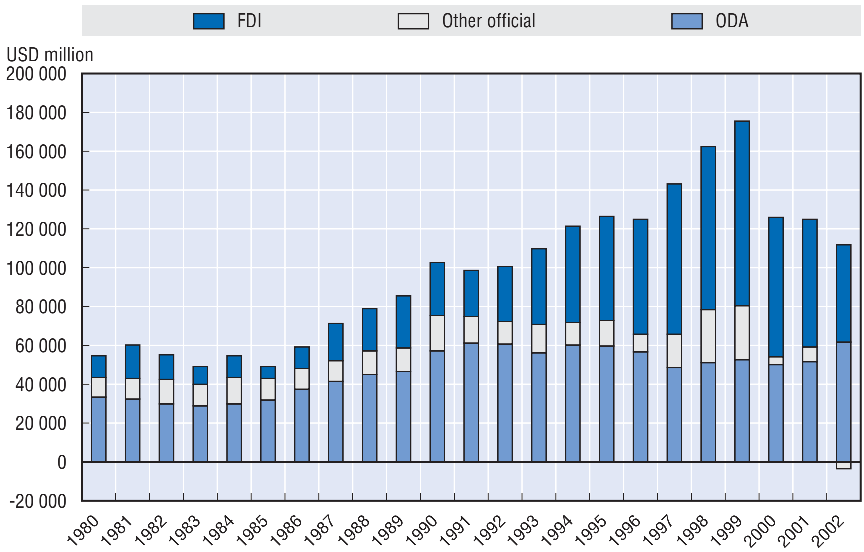
Efforts at enhancing the standard of living in developing countries are guided by the United Nations' Millennium Development Goals (MDGs). It is clear to most observers that financing the MDGs will rely first and foremost on mobilising domestic resources, supplemented by external financing, such as FDI and official development assistance (ODA). The Monterrey Consensus, adopted in March 2002 in support of the Millennium Development Goals, highlights the need for policies within developing countries to mobilise domestic resources and attract private investment, and for utilising aid effectively. In turn, the international community committed to scale up and intensify their efforts to help developing countries by, among other things, improving synergies between ODA and FDI.

FDI is a valuable supplement to development assistance

ODA is now recovering from all time low levels and further increases are expected up until 2006. In 2002, ODA totalled USD 58 billion, an increase in real terms of 7 per cent over 2001 and the highest real level achieved since 1992. The increase has been quite broad-based across members of OECD's Development Assistance Committee (from whom data are available). In the Monterrey Consensus, donors pledged to increase aid to support the MDGs. Secretariat estimates based on members' commitments and plans indicate that ODA should increase by 32 per cent in real terms over 2002-06 (USD 19 billion), raising the ODA/GNI level from 0.23 per cent in 2002 to 0.29 per cent in 2006.

Again, the ODA/FDI has gained in importance because ODA is widely perceived as insufficient as developing countries' main source of external finance. Alternative source of funds include "other official flows" (*i.e.* non-concessionary public finance), but these have dwindled in recent years and in 2002 even turned negative (Figure 1.6). Private capital flows other than FDI (*e.g.* bank loans, portfolio investment) have in some cases been the major source of finance for the developing world, but they are notoriously volatile. Between the mid-1980s and 1990 and again in 2001 and 2002 there was a considerable withdrawal of this "other" private capital from the developing world.[10]

Figure 1.6. **Net capital flows from all donors to all developing countries**



Source: Development Assistance Committee.

FDI has advantages over other international financial flows

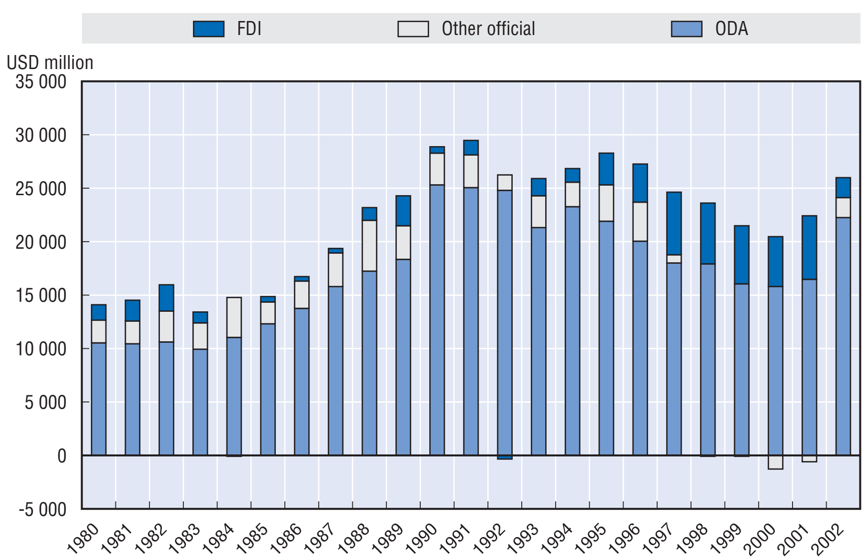
Direct investment, on the contrary, has proven to be a generally more resilient source of financing.[11] In recent years, gross FDI flows into developing countries have been more than twice the level of aid flows. Figure 1.6 indicates that, even when applying the narrower measure of net FDI flows from OECD countries to developing countries (which is arguably a more suitable measure for comparing FDI with ODA),[12] the contribution of FDI to the external financing of developing countries has been growing steadily relative to that of ODA over the last twenty years. Furthermore, the amount of FDI among developing countries themselves (the so-called "south-south investment") has increased in the last decade, and while this does not entail a resource transfer to the developing world as a whole, it is nevertheless likely to have had a positive developmental impact.

Direct comparisons of ODA and FDI, and the impact so far of FDI to alleviate financial constraints across a larger group of developing countries, are, however, not straightforward. For instance, a couple of problems relate to often very different national and sectoral distribution of the two. First, according to a well-known adage, almost all of the ODA goes to the poorest countries while almost all of the FDI goes to the middle-income countries.

Second, even within the group of middle-income developing countries, FDI is concentrated heavily on a few dozens of nations which possess natural resources or are otherwise particularly attractive for investors. These observations are underpinned by the reality of the world's poorest continent, Africa, which continues to be overwhelmingly dependent on aid for its external finance, although it should be noted that FDI did grow from previously very low levels during the 1990s (Figure 1.7).

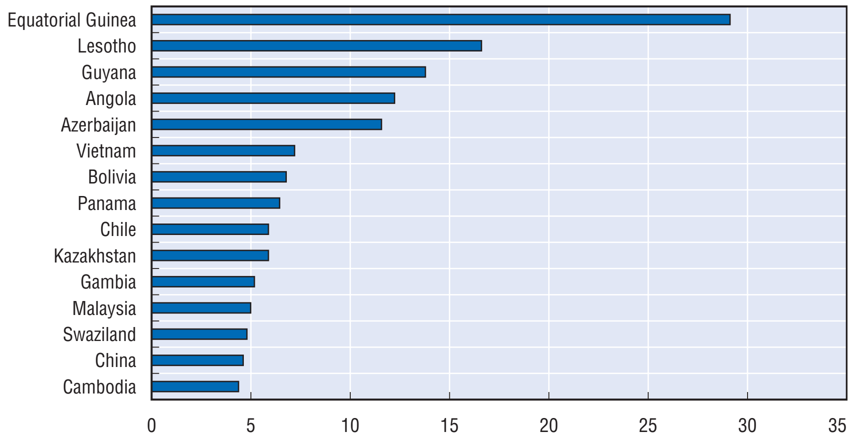
The concentration argument should, however, not be exaggerated. It is true that China attracted almost one third of the developing world's FDI in 2002 (though less so when regional flows are discarded) and briefly became the world's foremost recipient of direct investment, but this needs to be seen relative to the size of the Chinese economy. A measure of FDI's potential benefits to the host country's economic performance is the net inflows relative to domestic value added. Measured thus, the fifteen main developing country recipients of FDI contain several countries that are not usually considered as important FDI recipients[13] (Figure 1.8). It must be recognised that some of them have attracted investment largely as a result of resource availability (*e.g.* Equatorial Guinea, Angola, Azerbaijan and Kazakhstan), and others due to the proximity of a comparatively wealthy neighbour (*e.g.* Swaziland, Lesotho). Others have, however, been able to attract broad-based FDI whose potential domestic economic impact easily rivals that of the largest recipients of direct investment.

Figure 1.7. **Net capital flows from all donors to all developing countries**



Source: Development Assistance Committee.

Figure 1.8. **The major recipients of FDI as percentage of GDP, 1992-2001**



Source: World Bank Development Indicators.

FDI is not a substitute for domestic investment

Even as FDI apparently has considerable potential to supplement and complement ODA as a source of external finance, it should be kept in mind that the main source of sustainable growth in most developing countries will be domestic capital accumulation. In this context, it should also be noted that a large share of the upsurge of FDI into the developing world in the mid- and late 1990s was motivated by the privatisation of public utilities in several countries[14] (see also box 1.1). While the positive development impact of international strategic investors' participation in privatisation is well documented,[15] and while the proceeds from the privatisations may eventually be sunk into fixed investment, the short-term effect on domestic capital formation of such FDI is limited. Consequently, measures such as FDI relative to domestic investment tend to provide a high-end estimate.

According to the World Bank's World Development Indicators, which offer data for FDI and gross capital formation in over 130 developing countries, the average share of FDI in total fixed investment over the last decade has been around 15 per cent. The national variations were, however, considerable. In certain resource-rich countries such as Angola, Sudan and Venezuela FDI accounted for at least half of fixed domestic investment, whereas, at the opposite end, Iran, Niger, Sierra Leone, Haiti, Bangladesh and several (other) less-developed countries had almost no direct foreign private involvement in their fixed investment.

As regards the policy options for using ODA in support of investment, the separation of FDI from fixed domestic investment may in most cases be an

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Box 1.1. **FDI in developing countries: a shift to services**

FDI flows to developing countries' service sectors increased rapidly in the late 1980s and early 1990s. Between 1988 and 1999, service sector FDI increased at an annual rate of 28 per cent and accounted for around 37 per cent of total FDI inward stocks in developing countries in 1999. The share of infrastructure in total FDI flows nearly doubled during the period 1990 to 1998. This increase was led by a surge in flows into the telecommunications sector (the increase was around USD 84 billion, or one-tenth of the change in aggregate FDI stock) as global telecom and utility companies took advantage of their rising stock prices and participated in privatization programmes in many developing countries. Such investment peaked in 1998, however, in line with the asset price movements in the information, communication and technology sectors in global markets. Also, privatisation efforts began to slow around this period in many developing countries.

Despite the slump in the telecommunication sector since 1998, developing countries have continued to receive FDI into this sector. The profile of investors is, however, changing. A growing number of new (relatively small) regional firms are now competing with the global players. The mode of investments is changing as well, from privatisation to licensing and joint ventures.

This shift toward services is likely to have increased the benefits of FDI to developing countries. Foreign-owned service companies can be an important source of spillovers to the domestic business sectors, particularly compared with the often limited linkages between extractive industries and the host economies. For example, the entry of foreign banks has helped improve the efficiency of developing countries' financial sectors, a critical input to growth.

Source: Global Development Finance 2003, World Bank.

artificial one. Foreign and domestic companies respond to the same inducements and disincentives to invest, and their assessments of the investment climate in a given host location tend to converge. Domestic investors are sometimes more resilient to shortcomings in governance than foreign companies, owing to their inside knowledge of the host country's social and economic structures. Also, micro-enterprises and producers operating on the edges of the formal economy (*e.g.* subsistence farmers) may have altogether different perceptions of the investment climate, but private companies operating on a fully commercial basis can in most contexts be treated as equivalent. ODA-backed efforts to enhance the investment climate is relevant in the context of attracting FDI, in mobilising domestic funds for investment and in enhancing the contribution of any kind of investment to economic development.

Notes

1. Technically, Luxembourg was the largest recipient. However, this is widely considered to be due to the large matching in- and outflows through holding companies and other special purpose entities located in this country.
2. This problem is not limited to Spain. Several of the smaller West European countries are believed to record inflated gross direct investment flows because of comparable corporate structures.
3. Depending on whether or not one includes Luxembourg in the comparison.
4. The World Bank (2004), *Global Development Finance: Harnessing Cyclical Gains for Development*.
5. Calculated from IMF, *International Financial Statistics* FDI inflow and population figures.
6. The quarterly statistics referred to in this section are balance of payment data reported to the OECD by member countries in the context of the OECD Main Economic Indicators.
7. UNCTAD (2004), "Prospects for FDI Flows and TNC Strategies, 2004-07", Research Note No. 3.
8. According to available statistics, Luxembourg appears prominently on the league table. However, this country is omitted here as the observation is thought to reflect investment into special purpose entities.
9. Some caution is nevertheless called for: the figures may be biased by intra-OECD flows. When, for instance, a financial entity acquires a manufacturing company, the resultant statistics show a net service outflow and a net manufacturing inflow.
10. The implications of this are discussed by Dailami, M., H. Kalsi and W. Shaw (2003), "Coping with Weak Private Debt Flows", *Global Development Finance: Striving for Stability in Development Finance*, World Bank.
11. This point was for instance made in OECD (2002), *Foreign Direct Investment for Development – Maximising Benefits, Minimising Costs*, pp. 60-61.
12. However, this measure fails to take into account FDI flows from wealthy countries other than OECD members to developing countries. During the 1990s such flows accounted for roughly 15-20 per cent of FDI to the developing world.
13. Small island states and off-shore financial centres have been omitted from the sample.
14. For further detail, see Aykut, D., H. Kalsi and D. Ratha (2003), "Sustaining and Promoting Equity-Related Finance for Developing Countries", World Bank.
15. See for example La Porta, R. and F. Lopez de Silanes (1997), "The benefits of privatization: evidence from Mexico", *NBER Working Paper*, No. 6215, and Bortolotti, B., J. d'Sousa, M. Fantini and W. Megginson (2001), "Sources of performance improvements in privates firms: a clinical study of the global telecommunications industry", *University of Oklahoma Department of Finance Working Paper/FEEM Working Paper*, No. 26.

ANNEX 1.A1

International Direct Investment Statistics

Table 1.A1.1. **OECD direct investment abroad: outflows**

USD million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002p	2003e
Australia	992.3	1 199.4	5 266.9	1 947.0	2 816.5	3 281.8	7 087.6	6 427.9	3 344.8	–420.7	655.1	12 218.8	7 632.7	14 291.3
Austria	1 627.2	1 285.3	1 697.5	1 190.5	1 257.2	1 130.6	1 935.0	1 988.2	2 745.2	3 300.7	5 740.9	3 137.9	5 256.2	7 089.9
Belgium/Luxembourg	5 956.0	6 066.2	10 955.9	3 850.5	1 205.4	11 728.4	7 811.3	7 884.5	29 107.8	132 325.8	218 364.4	100 624.7	. .	. .
Belgium	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	10 952.3	38 959.6
Canada	5 235.2	5 832.3	3 589.2	5 699.9	9 293.5	11 462.3	13 094.3	23 059.2	34 349.2	17 250.1	44 678.5	36 113.4	26 415.3	21 558.8
Czech Republic	. .	. .	. .	90.2	119.6	36.6	152.9	25.2	127.1	89.8	42.8	165.4	206.5	232.7
Denmark	1 618.2	2 051.8	2 236.0	1 260.5	3 955.1	3 063.5	2 519.1	4 206.6	4 476.6	16 988.4	26 542.2	13 376.8	5 694.0	1 158.7
Finland	2 708.5	–124.0	–751.7	1 407.1	4 297.8	1 497.3	3 596.5	5 291.7	18 641.5	6 615.5	24 034.7	8 372.0	7 629.1	–7 381.4
France	36 228.4	25 137.6	30 407.1	19 736.1	24 372.3	15 758.1	30 419.5	35 580.9	48 612.7	126 859.2	177 481.6	86 783.3	49 478.1	57 332.8
Germany	24 231.9	22 947.0	18 595.1	17 196.1	18 857.8	39 051.6	50 806.3	41 794.1	88 837.2	108 691.6	56 567.5	36 861.4	8 629.9	2 561.9
Greece	. .	. .	. .	. .	. .	. .	. .	. .	–283.9	551.9	2 136.9	616.7	655.9	46.7
Hungary	. .	. .	. .	10.6	48.3	59.1	–3.6	461.9	278.3	250.1	620.2	368.1	275.0	1 581.1
Iceland	11.5	28.6	6.3	14.3	23.7	24.8	63.4	56.0	74.1	123.1	392.6	341.8	214.9	165.1
Ireland	364.7	192.6	214.4	217.8	436.3	819.8	727.9	1 013.7	3 902.1	6 109.1	4 629.6	4 066.1	3 086.9	1 908.0
Italy	7 611.7	7 325.9	5 948.5	7 230.6	5 108.8	5 731.4	6 464.9	12 244.7	16 077.6	6 721.7	12 318.5	21 475.9	17 138.3	9 127.9
Japan	50 773.5	31 687.7	17 304.8	13 914.4	18 116.0	22 632.1	23 414.8	25 991.7	24 157.7	22 750.0	31 540.4	38 352.0	32 283.3	28 799.4
Korea	1 051.6	1 488.6	1 161.5	1 340.0	2 461.1	3 552.0	4 670.1	4 449.4	4 739.5	4 197.8	4 998.9	2 420.1	2 616.5	3 429.2
Luxembourg	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	126 228.5	81 813.1
Mexico	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	4 404.0	969.0	. .
Netherlands	13 660.6	12 825.9	12 697.1	10 063.3	17 553.8	20 175.5	32 098.1	24 522.1	36 475.1	57 611.3	75 648.7	47 977.3	34 584.6	36 126.3
New Zealand	2 360.7	1 472.4	391.4	–1 388.7	2 008.2	1 783.5	–1 239.7	–1 565.5	401.4	1 072.5	608.7	911.9	–1 038.8	–66.2
Norway	1 431.5	1 823.6	394.2	933.0	2 172.5	2 856.2	5 892.5	5 015.3	3 200.7	5 503.6	7 613.8	–1 322.7	4 200.7	2 565.2
Poland	. .	. .	13.0	18.0	29.0	42.0	53.0	45.0	316.0	31.3	17.2	–89.0	230.0	386.0
Portugal	164.8	473.6	684.2	107.3	282.5	684.6	785.4	1 926.2	3 845.9	3 168.4	7 513.8	7 565.6	3 291.3	96.0
Slovak Republic	. .	. .	. .	12.8	17.7	43.0	62.9	95.1	146.6	–377.2	28.7	64.5	11.2	13.3
Spain	3 441.7	4 424.4	2 171.0	3 173.6	4 110.8	4 157.8	5 590.1	12 546.8	18 937.7	42 084.5	54 684.6	33 099.5	31 540.2	23 395.0
Sweden	14 748.2	7 057.6	408.7	1 357.7	6 701.1	11 214.3	5 024.8	12 647.5	24 379.4	21 928.6	40 667.3	6 374.9	10 679.9	10 587.5
Switzerland	7 176.9	6 542.5	6 058.5	8 765.4	10 798.0	12 213.9	16 150.8	17 747.9	18 768.8	33 264.3	44 698.1	18 246.6	7 586.7	10 921.1
Turkey	–16.0	27.0	65.0	14.0	49.0	113.0	110.0	251.0	367.0	645.0	870.0	497.0	175.0	499.0
United Kingdom	17 953.8	16 412.1	17 740.9	26 063.1	32 205.7	43 560.0	34 055.9	61 620.0	122 861.2	201 436.7	233 487.7	58 885.2	35 213.0	55 316.4
United States	37 183.0	37 889.0	48 266.0	83 950.0	80 167.0	98 750.0	91 885.0	104 803.0	142 644.0	224 934.0	159 212.0	142 349.0	134 835.0	173 799.0
Total OECD	**236 516.1**	**194 067.1**	**185 521.7**	**208 175.1**	**248 464.9**	**315 423.1**	**343 228.6**	**410 130.3**	**651 531.3**	**1 043 706.9**	**1 235 795.2**	**684 258.2**	**566 671.0**	**576 313.5**

Note: Data are converted to US dollars using average exchange rates.
p Preliminary.
e Estimate.
Source: OECD International Direct Investment Database.

Table 1.A1.2. **OECD direct investment from abroad: inflows**

USD million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002p	2003e
Australia	8 115.8	4 302.1	5 719.8	4 281.7	5 024.6	11 963.2	6 111.0	7 633.4	6 002.6	3 268.4	13 198.7	4 678.7	16 456.9	7 848.2
Austria	650.9	351.3	1 432.7	1 136.5	2 102.9	1 904.2	4 428.6	2 655.6	4 534.1	2 974.6	8 841.7	5 920.5	953.3	6 861.7
Belgium/Luxembourg	7 516.0	8 919.4	10 957.3	10 467.8	8 313.2	10 894.2	13 924.4	16 510.1	30 146.9	142 512.3	220 987.8	84 717.6	..	..
Belgium	..	..	..	..	..	..	..	..	..	..	..	..	13 083.1	31 345.5
Canada	7 580.3	2 880.0	4 721.6	4 730.3	8 204.1	9 255.4	9 632.6	11 522.0	22 802.8	24 747.2	66 795.5	27 487.1	21 035.7	6 585.3
Czech Republic	..	..	..	653.4	868.3	2 561.9	1 428.2	1 301.1	3 716.4	6 326.2	4 980.2	5 644.6	8 483.5	2 591.6
Denmark	1 206.7	1 459.9	1 014.7	1 669.0	4 897.6	4 179.8	768.0	2 798.6	7 725.7	16 741.4	33 797.5	11 527.6	6 646.1	2 609.4
Finland	787.5	–246.6	406.2	864.4	1 577.7	1 062.9	1 109.0	2 115.8	12 140.7	4 610.2	8 835.6	3 732.2	7 926.7	2 767.7
France	15 612.6	15 170.9	17 849.2	16 442.7	15 574.0	23 679.1	21 959.5	23 171.5	30 984.5	46 545.9	43 258.4	50 485.1	48 949.7	47 025.5
Germany	2 962.0	4 729.3	–2 088.9	368.3	7 133.9	12 025.4	6 572.8	12 243.4	24 596.7	56 077.3	198 313.0	21 142.2	36 047.9	12 878.0
Greece	1 688.4	1 718.1	1 588.6	1 243.6	1 166.1	1 197.7	1 196.4	1 088.6	73.9	561.5	1 108.6	1 589.5	50.1	661.8
Hungary	312.1	1 474.4	1 477.2	2 446.2	1 143.5	5 101.9	3 300.4	4 170.9	3 337.1	3 313.1	2 763.0	3 936.0	2 844.6	2 470.0
Iceland	22.0	18.2	–12.7	0.4	–1.5	9.2	83.1	147.9	147.8	66.6	170.5	172.6	121.6	84.4
Ireland	622.6	1 360.8	1 458.1	1 068.5	856.2	1 441.5	2 615.7	2 709.6	8 856.5	18 210.1	25 783.3	9 652.7	24 392.4	25 463.2
Italy	6 343.4	2 481.5	3 210.8	3 751.4	2 235.6	4 816.2	3 534.9	4 962.5	4 279.8	6 911.4	13 377.3	14 873.4	14 558.2	16 979.2
Japan	1 809.4	1 286.2	2 755.2	206.9	890.1	42.5	229.7	3 223.1	3 193.5	12 740.4	8 318.6	6 247.9	9 243.2	6 322.2
Korea	788.5	1 179.8	728.3	588.1	809.0	1 775.8	2 325.4	2 844.2	5 412.3	9 333.4	9 283.4	3 527.7	2 392.3	3 222.0
Luxembourg	..	..	..	..	..	..	..	..	..	..	..	..	117 088.2	73 191.4
Mexico	2 633.0	4 761.0	4 393.0	4 389.0	10 973.0	9 647.0	9 943.0	14 160.0	12 170.0	13 165.7	16 448.7	26 569.3	14 435.3	10 731.5
Netherlands	10 516.2	5 778.9	6 169.4	6 443.1	7 158.4	12 306.8	16 660.1	11 136.5	36 924.9	41 206.1	63 865.6	51 936.8	25 593.4	19 692.7
New Zealand	1 683.1	1 695.6	1 089.2	2 211.6	2 615.7	2 849.7	3 922.0	1 917.2	1 825.5	940.4	1 344.4	4 198.0	–556.0	835.9
Norway	1 176.7	–48.9	810.4	1 460.7	2 777.6	2 408.0	3 168.5	3 946.4	4 353.7	7 061.7	6 907.7	2 009.3	679.0	2 189.6
Poland	88.0	359.0	678.0	1 715.0	1 875.0	3 659.0	4 498.0	4 908.2	6 364.9	7 269.6	9 341.0	5 713.0	4 131.0	4 225.0
Portugal	2 255.4	2 291.6	1 903.8	1 516.2	1 254.6	660.1	1 488.5	2 478.8	3 143.5	1 233.5	6 788.6	5 893.7	1 846.3	962.5
Slovak Republic	..	..	..	179.1	272.9	241.4	395.7	230.6	706.8	428.5	2 383.1	1 584.1	4 126.5	593.8
Spain	13 838.6	12 445.2	13 350.7	9 571.6	9 275.8	6 285.1	6 820.6	6 387.8	11 798.4	15 758.8	37 530.2	28 010.1	35 939.8	25 649.3
Sweden	1 971.4	6 355.8	41.0	3 845.1	6 349.7	14 446.9	5 436.6	10 967.4	19 842.7	60 929.1	23 245.5	11 900.1	11 643.6	3 435.8
Switzerland	5 484.9	2 642.8	411.2	–83.3	3 368.4	2 223.2	3 078.2	6 641.8	8 941.9	11 714.0	19 266.0	8 858.9	5 655.8	12 162.3
Turkey	684.0	810.0	844.0	636.0	608.0	885.0	722.0	805.0	940.0	783.0	982.0	3 266.0	1 038.0	575.0
United Kingdom	30 470.7	14 849.2	15 474.8	14 821.3	9 254.6	19 968.4	24 441.3	33 244.9	74 348.9	87 972.8	118 823.8	52 650.2	27 802.3	14 573.8
United States	48 494.0	23 171.0	19 823.0	51 362.0	46 121.0	57 776.0	86 502.0	105 603.0	179 045.0	289 444.0	321 274.0	167 021.0	72 411.0	39 890.0
Total OECD	**175 314.4**	**122 196.5**	**116 206.5**	**147 986.6**	**162 699.9**	**225 267.7**	**246 296.4**	**301 525.8**	**528 357.4**	**892 847.2**	**1 288 013.6**	**624 946.0**	**535 019.5**	**384 424.2**

Note: Data are converted to US dollars using average exchange rates.

p Preliminary.

e Estimate.

Source: OECD International Direct Investment Database.

Table 1.A1.3. **OECD direct investment abroad: outward position**

USD million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002p	2003e
Australia	30 494.9	30 897.0	34 559.6	40 503.6	47 786.3	53 009.0	66 857.9	71 968.4	78 647.9	89 583.6	83 442.4	90 717.3	91 380.1	125 778.0
Austria	4 746.9	5 993.6	6 584.5	7 974.2	9 514.1	11 832.0	13 059.8	14 011.4	17 468.4	19 127.3	24 819.9	28 510.6	39 744.1	55 824.6
Belgium/Luxembourg	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Belgium	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Canada	84 812.7	94 387.4	87 867.3	92 469.1	104 308.0	118 106.1	132 321.9	152 959.3	171 784.7	201 446.8	237 646.9	250 441.1	272 000.7	308 849.9
Czech Republic	..	..	..	181.4	300.4	345.5	498.0	548.2	804.1	697.9	737.9	1 135.6	1 473.1	1 911.6
Denmark	..	15 612.0	16 305.7	15 799.2	19 613.7	24 702.5	27 601.6	28 127.7	34 857.3	45 574.7	66 227.8	70 133.3	75 913.6	..
Finland	11 227.3	10 845.3	8 564.6	9 178.2	12 534.0	14 993.2	17 666.0	20 297.5	29 405.9	33 850.3	52 108.7	52 224.4	63 920.9	68 702.1
France	110 120.6	129 900.5	156 326.6	158 750.3	182 331.8	204 430.3	231 112.8	237 248.9	288 035.9	334 102.9	445 087.0	508 842.0	586 095.8	..
Germany	130 760.3	150 517.4	154 741.3	162 365.0	194 523.4	233 107.4	248 634.1	296 274.9	365 195.7	411 952.0	484 854.4	545 168.8	654 927.6	..
Greece	..	..	..	..	..	..	..	..	2 792.2	3 217.9	5 851.7	7 020.4	9 000.6	..
Hungary	..	..	223.6	224.6	291.2	278.1	265.3	646.6	785.1	924.2	1 279.1	1 554.5	2 161.4	3 921.1
Iceland	75.2	101.1	98.1	113.5	148.5	177.2	240.1	275.0	360.5	451.8	662.9	840.2	1 111.6	1 420.7
Ireland	..	..	..	..	..	..	..	..	20 314.4	25 232.1	27 925.0	34 336.8	34 769.3	..
Italy	60 195.3	70 419.3	70 382.3	81 086.6	89 688.3	106 318.6	117 278.0	139 437.2	176 985.2	181 855.5	180 273.6	182 373.3	194 488.3	..
Japan	201 440.0	231 790.0	248 060.0	259 800.0	275 570.0	238 452.0	258 608.9	271 905.7	270 037.5	248 778.0	278 444.1	300 116.4	304 234.1	335 503.3
Korea	..	..	..	..	..	..	..	..	..	..	..	19 967.0	22 578.0	..
Luxembourg	..	..	..	..	..	4 703.4	4 695.4	5 022.4	7 982.8	8 467.8	7 927.0	8 592.8	..	..
Mexico	..	..	..	..	..	..	..	..	..	..	..	..	13 187.3	14 156.3
Netherlands	102 599.7	112 184.8	116 012.8	114 657.5	138 786.0	167 073.7	190 580.6	194 247.1	220 707.1	253 812.5	296 671.6	322 208.5	374 191.5	..
New Zealand	..	..	5 899.0	4 430.7	5 896.2	7 675.6	9 293.1	5 646.0	5 490.8	7 006.2	6 065.1	7 608.6	7 759.0	8 417.5
Norway	10 889.2	12 149.1	11 794.4	12 717.7	17 648.0	22 520.7	25 439.1	27 494.5	31 578.2	31 871.3	33 651.4	..	..	..
Poland	..	..	101.0	198.0	461.0	539.0	735.0	678.0	1 165.0	1 024.1	1 018.0	1 156.0	1 453.0	..
Portugal	..	..	..	..	..	4 406.3	3 953.9	5 414.0	9 622.4	10 330.8	17 169.7	23 490.5	31 870.5	38 543.1
Slovak Republic	..	..	..	..	166.4	138.5	185.0	236.4	408.2	346.0	379.1	506.6	485.6	633.2
Spain	..	..	22 034.4	24 017.8	30 049.5	36 221.1	40 537.6	50 272.2	70 056.1	112 793.3	159 901.8	184 711.7	225 191.3	281 687.0
Sweden	50 719.5	54 797.6	48 844.6	45 522.5	60 309.0	73 142.5	72 187.8	78 201.2	93 533.7	106 273.8	123 234.0	122 893.1	144 356.9	189 408.5
Switzerland	66 086.9	75 880.8	74 412.2	91 570.3	112 588.0	142 481.4	141 586.8	165 354.1	184 237.1	194 598.5	233 385.2	253 551.9	295 402.6	344 115.9
Turkey	..	..	..	..	..	..	..	..	..	..	3 668.0	4 581.0	5 047.0	..
United Kingdom	229 306.7	232 140.8	221 678.9	245 628.9	276 743.8	304 864.9	330 432.5	360 796.3	488 372.0	686 420.4	897 844.8	869 700.5	921 445.1	1 128 583.6
United States	616 655.0	643 364.0	663 830.0	723 526.0	786 565.0	885 506.0	989 810.0	1 068 063.0	1 196 021.0	1 414 355.0	1 529 725.0	1 598 072.0	1 751 852.0	..
Total OECD	**1 710 130.1**	**1 870 980.6**	**1 948 320.8**	**2 090 714.9**	**2 365 822.7**	**2 655 025.0**	**2 923 581.2**	**3 195 125.9**	**3 766 649.3**	**4 424 094.8**	**5 200 002.1**	**5 490 454.8**	**6 126 041.2**	**..**

Note: Data are converted to US dollars using average exchange rates.

p Preliminary.

e Estimate.

Source: OECD International Direct Investment Database.

Table 1.A1.4. **OECD direct investment from abroad: inward position**

USD million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002p	2003e
Australia	73 615.1	77 077.7	75 821.7	82 877.7	95 543.8	104 074.3	116 797.2	101 089.0	105 961.7	120 625.7	109 288.1	107 218.0	131 607.5	179 481.0
Austria	10 971.8	11 510.1	12 040.8	12 105.5	14 636.0	19 721.0	19 629.2	19 522.2	23 564.8	23 471.6	30 430.8	34 328.0	41 946.3	58 098.0
Belgium/Luxembourg	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Belgium	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Canada	112 850.3	117 031.5	108 500.1	106 869.7	110 210.1	123 182.3	132 970.2	135 935.6	143 348.8	175 000.9	212 722.7	214 120.8	220 899.4	276 670.6
Czech Republic	..	..	..	3 422.8	4 546.6	7 349.8	8 573.1	9 233.2	14 377.1	17 549.5	21 647.0	27 092.8	38 672.3	47 526.9
Denmark	..	14 747.0	14 387.3	14 617.9	17 846.3	23 800.9	22 337.0	22 267.8	31 175.6	42 053.3	66 711.5	67 408.7	73 587.2	..
Finland	5 132.4	4 220.5	3 688.9	4 216.7	6 714.1	8 464.5	8 797.5	9 529.8	16 454.8	18 320.4	24 272.3	24 069.8	34 005.9	46 400.1
France	84 930.9	97 450.5	127 881.4	135 077.8	163 451.4	191 433.0	200 095.8	195 913.0	246 215.9	244 672.5	259 773.0	295 308.0	386 524.7	..
Germany	74 066.8	77 927.8	74 730.1	71 095.4	85 904.8	102 491.2	102 652.9	188 874.3	250 319.9	288 562.4	460 631.8	404 497.2	510 208.7	..
Greece	..	..	..	..	..	..	..	..	13 088.1	15 533.3	12 479.4	13 638.8	15 560.0	..
Hungary	568.8	2 106.7	3 424.1	5 575.6	7 083.5	11 303.5	13 274.9	17 953.6	20 752.9	23 259.7	22 856.2	27 377.5	35 879.4	42 918.7
Iceland	147.1	165.6	123.8	116.5	127.5	148.7	197.4	331.9	468.7	478.4	491.4	676.5	762.8	769.8
Ireland	..	..	..	..	..	..	..	..	62 453.1	72 817.0	118 549.4	143 949.9	184 693.8	..
Italy	60 008.5	61 592.3	49 972.7	53 961.9	60 416.0	65 347.2	74 599.9	85 401.8	108 835.3	108 640.7	113 046.4	108 005.6	126 474.4	..
Japan	9 850.0	12 290.0	15 510.0	16 890.0	19 170.0	33 507.7	29 937.1	27 077.5	26 064.8	46 115.3	50 322.8	50 319.7	78 142.8	89 728.3
Korea	..	..	..	..	..	..	..	..	..	..	..	53 208.0	62 658.0	..
Luxembourg	..	..	..	..	..	18 503.5	18 232.8	17 279.6	20 766.1	20 362.0	23 491.7	25 631.6	..	..
Mexico	22 424.4	30 790.0	35 680.0	40 600.4	33 197.7	41 129.6	46 912.0	55 810.0	63 610.4	78 060.0	97 170.2	140 376.0	154 344.0	..
Netherlands	66 926.8	70 177.0	71 841.0	72 167.1	90 504.7	112 139.3	125 009.7	120 587.2	160 479.3	187 822.0	238 938.3	276 408.7	344 129.6	..
New Zealand	..	..	11 779.5	15 539.1	22 062.2	25 727.6	34 743.7	31 365.3	33 169.9	32 860.8	28 069.8	22 102.5	27 544.9	34 176.0
Norway	12 403.8	15 865.2	13 644.9	13 642.5	17 018.0	19 835.9	20 623.8	20 704.4	26 081.4	29 433.0	30 261.4	32 589.6	42 649.2	..
Poland	109.0	425.0	1 370.0	2 307.0	3 789.0	7 843.0	11 463.4	14 587.2	22 479.0	26 075.3	34 227.0	41 247.0	47 900.0	..
Portugal	..	..	..	..	..	18 162.1	19 861.1	19 305.9	24 465.6	24 148.4	29 040.2	34 572.9	43 195.5	53 527.5
Slovak Republic	..	..	..	..	897.0	1 297.1	1 899.8	2 103.4	2 919.6	3 227.6	4 679.4	5 729.8	8 530.6	11 283.9
Spain	..	..	85 958.0	80 268.9	96 302.4	109 116.4	108 016.5	100 101.6	118 248.5	115 985.6	144 932.3	165 255.2	236 257.3	312 637.0
Sweden	12 636.0	18 085.0	14 057.0	13 126.9	22 649.4	31 089.3	34 784.1	41 512.7	50 984.6	73 312.5	93 972.5	92 240.2	117 955.7	143 328.7
Switzerland	34 244.6	35 747.2	32 989.3	38 713.5	48 668.4	57 063.7	53 916.7	59 515.2	71 997.1	76 000.2	86 809.8	88 766.3	125 079.0	153 725.8
Turkey	..	..	..	..	..	..	..	..	..	..	19 209.0	19 677.0	17 621.0	..
United Kingdom	203 905.3	208 345.5	172 986.4	179 232.6	189 587.5	199 771.8	228 642.5	252 958.6	337 386.1	385 146.1	438 630.7	506 685.6	568 259.4	672 014.5
United States	505 346.0	533 404.0	540 270.0	593 313.0	617 982.0	680 066.0	745 619.0	824 136.0	920 044.0	1 101 709.0	1 418 523.0	1 514 374.0	1 504 428.0	..
Total OECD	**1 290 137.5**	**1 388 958.6**	**1 466 657.0**	**1 555 738.2**	**1 728 308.1**	**2 012 569.6**	**2 179 586.8**	**2 373 096.7**	**2 915 712.9**	**3 351 243.1**	**4 191 178.0**	**4 536 876.0**	**5 179 517.3**	..

Note: Data are converted to US dollars using average exchange rates.

p Preliminary.

e Estimate.

Source: OECD International Direct Investment Database.

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Chapter 2

Russia's Policies towards Foreign Investment: Clearing the Path*

The Russian Federation needs more foreign direct investment (FDI) as it seeks to modernise its economy and diversify towards an economic structure less dependent on natural resources. The Russian federal administration has carried forward the liberalisation of the Russian economy, further enhancing the business environment for investment. However, some formal restrictions on FDI persist, and in addition there are several non-discriminatory obstacles to investment which may have a discouraging effect on foreign investors. The OECD proposes a number of policy options for the Russian government to consider in further removing obstacles to FDI. These include relaxation of remaining foreign ownership restrictions in the financial services and other sectors, further improvements in corporate governance, maintaining efforts to ensure federal/regional policy coherence and simplify administrative procedures, developing a level playing field for the privatisation of state-owned enterprises, and persevering with efforts to enhance the legal system, ensure fairness and non-discrimination in tax collection and fight corruption.

This article is based on the forthcoming publication Investment Policy Review of the Russian Federation, OECD (2004).

* This article was prepared by Kenneth Davies, Investment Division, OECD, on the basis of material prepared by Eva Thiel and Kenneth Davies for the publication *Investment Policy Review of the Russian Federation*, OECD (2004), forthcoming.

Although the Russian Federation opened its economy to foreign investment in the 1990s, it has so far not received as much foreign direct investment (FDI) as other major transition economies. FDI is therefore not yet fulfilling its potential as a catalyst for Russia's economic development, not least because it is heavily skewed towards a few regions and sectors. This article, which is based on a forthcoming policy study by the OECD,[1] examines the development of the Russian government's investment policies and offers policy options designed to remove remaining obstacles to FDI.

1. The benefits of an increasing FDI

1.1. The potential role of FDI in Russia's economic development

Russia needs FDI for several reasons. The country tends to suffer from a low rate of capital investment which restricts its economic growth potential: gross fixed capital formation is a far smaller proportion of GDP than in other countries at a comparable stage of development.[2] One reason for this may be that the saving rate has fallen steadily, from 35 per cent in 1989 to 21 per cent in 2002,[3] but the problem has apparently been not merely a shortage of domestic savings to fund investment but also a lack of confidence of Russian investors in the Russian business environment, as indicated by the substantial capital flight that has occurred during most of the period.[4] If domestic investors prefer to operate in the business environment in other countries, the Russian investment environment may also not be sufficiently competitive to attract adequate inflows from abroad. Empirical studies have found that foreign investment in Russia was not driven primarily by demand but was highly responsive to indicators of reform and liberalisation.[5]

Foreign direct investment is needed not only to boost capital stocks, but also to improve the total factor productivity of Russian industry. A low productivity by international standards persists in many sectors, especially those which have little or no foreign ownership, no comparative advantage and a low proportion of exports to total output. Industrial sectors which have received a high degree of foreign investment, such as tobacco and brewing, are among those with the highest productivity growth. Labour productivity in the tobacco industry rose 74.8 per cent and that in brewing by 119.7 per cent in 1997-2002, contrasting with almost wholly-domestically-owned sectors such as electric power, gas and grain processing, where productivity fell during that period by 12.5 per cent, 27 per cent and 10.3 per cent respectively.[6]

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Recent research suggests that productivity of foreign firms is higher than that of Russian firms and that there is some spill over from foreign-owned to domestic enterprises.[7]

Increasing productivity is particularly important in Russia in the context of broadening the industrial base away from an excessive reliance on resource-based industries. The country relies heavily on earnings from fuel exports that has in the recent past pushed up exchange rates, rendering certain other sectors internationally uncompetitive. As pointed out in the *2004 OECD Economic Survey of Russia*,[8] "The non-resource tradable sector must increase productivity and restrain unit labour costs sufficiently to stay competitive in order either to export or at least to withstand imports".

1.2. Russia has received less FDI than other major transition economies

Russia's FDI performance remains poor compared to that of OECD countries. In 2003, Russia's total FDI inflow of 1.144 million US dollars (USD) was below that of all but six of the smaller OECD member economies[9] and its per capita FDI inflow of USD 27.6 in 2002 (Central Bank figure) was below that of all member countries.

A meaningful comparison is with the Central and East European transition economies, which commenced their transformation from centrally planned to market economy at approximately the same time as Russia and which, as former members of the Warsaw Pact and Comecon, came from a more closely comparable political and economic institutional background to that of the Russian Federation. The most successful of these in terms of overall economic development and, as part of that development, also in terms of attracting FDI, have been the Central European transition economies which are OECD members. All of these countries have at some stage outperformed Russia in terms of total FDI inflows, despite their vastly smaller populations and territories (see Table 2.1). Poland has consistently attracted more FDI than Russia, receiving an annual average of USD 5.2 billion in 1994-2003, compared to USD 2.6 billion for Russia. During that period, the Slovak Republic absorbed less

Table 2.1. **FDI inflows to Russia and Central European OECD members, 1994-2003**
USD million

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Russia	690.0	2 066.0	2 579.0	4 865.0	2 761.0	3 310.0	2 714.0	2 748.0	3 461.0	1 144.0
Czech Republic	868.3	2 561.9	1 428.2	1 301.1	3 716.4	6 326.2	4 980.2	5 644.6	8 433.5	2 591.6
Hungary	1 143.5	5 101.9	3 300.4	4 170.9	3 337.1	3 313.1	2 763.0	3 936.0	2 844.6	2 470.0
Poland	1 875.0	3 659.0	4 498.0	4 908.2	6 364.9	7 269.6	9 341.0	5 713.0	4 131.0	4 225.0
Slovak Republic	272.9	241.4	395.7	230.6	706.8	428.5	2 383.1	1 584.1	4 126.5	593.8

Source: CBR; International Investment Perspectives, OECD, 2003 edition.

than Russia (an annual average of USD 1.1 billion), while the Czech Republic received USD 3.8 billion and Hungary USD 3.3 billion.

Given the differences in population size, FDI per capita in Russia is far lower than in all the Central European transition economies. For example, Russia's per-capita FDI was only USD 27.6 in 2002, a typical year, when comparable figures ranged between USD 88.6 in Hungary and USD 817.8 in the Czech Republic (Table 2.2). Part of this difference can be explained by the proximity of the Central European transition economies to major investing countries in Western and Central Europe (and their prospective membership of the European Union[10]), but their attractiveness is also due to more developed institutional frameworks. Moreover, the composition of FDI inflows into the Central European transition economies is directed towards manufacturing and services and not primarily towards mineral extraction, as in Russia.

Table 2.2. **FDI inflow per head in Russia and Central European OECD members, 2002**

	USD
Russia	27.6
Czech Republic	817.8
Hungary	88.6
Poland	106.1
Slovak Republic	743.6

Source: CBR; International Investment Perspectives, OECD, 2003 edition; OECD web site, *Basic Structural Statistics*.

Cumulative FDI inflows up to the end of 2003 are officially reported by the Federal Service of State Statistics (FSSS, formerly the State Committee for Statistics, Goskomstat),[11] as totalling USD 26.1 billion. The bulk of this, 80 per cent, was recorded as having originated from 10 countries (Table 2.3). The largest contributor is listed as Cyprus, providing 19.3 per cent of the total, much of which is almost certainly returning flight capital or round-tripping investment from Russia itself; the remainder probably includes FDI indirectly routed from other countries. The US, the world's largest economy and a major provider of global FDI, is recorded as being in second place, accounting for 16.4 per cent of inward FDI flows to Russia. Investment from the British Virgin Islands, which is reported as constituting 2.7 per cent of cumulative FDI, is like that from Cyprus, mostly re-routed from elsewhere. An unknown, probably significant, proportion of FDI from other sources, such as the Netherlands, Switzerland and Luxembourg, could also originate from Russian investors.

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Table 2.3. **Cumulative foreign direct investment flows into the Russian Federation up to end-2003**

	Foreign direct investment inflow (USD million)	Proportion of total FDI inflow (%)
Total foreign direct investment	**26 131**	**100.0**
Cyprus	5 037	19.3
United States	4 297	16.4
United Kingdom	2 828	10.8
Netherlands	2 796	10.7
Germany	2 542	9.7
Japan	1 353	5.2
Switzerland	822	3.1
British Virgin Islands	718	2.7
France	331	1.3
Luxembourg	222	0.8

Source: Goskomstat.

1.3. FDI is unevenly distributed, both geographically and among sectors

FDI is distributed unevenly across the territory of the Russian Federation (Table 2.4). The Central Federal District (which includes Moscow) attracted 55.6 per cent of the national FDI inflow in 2002.[12] The second largest recipient was the Far East Federal District (where the bulk of FDI goes to Sakhalin), with 18.1 per cent. At the bottom of the range, the huge Siberian Federal District received only one per cent of Russia's FDI.

FDI in the Russian Federation is heavily skewed towards hydrocarbons. Since the gas sector is largely monopolised by a domestic company, Gazprom, almost all this investment is in oil extraction, which was reported as comprising over a quarter of the total FDI inflow in 2003. The other large

Table 2.4. **FDI by Federal District, 2002**

	Total FDI (USD thousand)	Percentage of total	FDI per capita (USD)
Central Federal District	2 223 851	55.6	58.54
North-Western Federal District	332 687	8.3	23.79
Southern Federal District	213 695	5.3	9.33
Volga Federal District	197 473	4.9	6.34
Urals Federal District	269 379	6.7	21.76
Siberian Federal District	41 293	1.0	2.06
Far East Federal District	724 181	18.1	108.30
Russian Federation	**4 002 559**	**100.0**	**27.57**

Source: Goskomstat.

recipient of FDI is the retail distribution sector, in particular food distribution, which was simultaneously reported as comprising one-fifth of the total.[13] This type of investment has mainly concerned large international producers of branded goods and services seeking access to the Russian market.

2. Russia's progress in developing policies towards foreign investment

Russia has made significant progress in opening its economy to foreign investment. This section examines the evolution of the legislative and regulatory framework relating to FDI, laying emphasis on developments which have occurred since the publication of the OECD's investment policy review of Russia in 2001.[14] Some of the most important recent improvements have been in areas which constitute part of the general business environment rather than in legislation relating directly to FDI, which was largely completed before 2001.

2.1. Laying the foundations

Foreign investment became possible in the former Soviet Union in 1987 when legislation on joint ventures was first introduced. In 1991, just before the dissolution of the Soviet Union, a Law on Foreign Investments in the Russian Socialist Republic was passed, allowing the establishment of wholly-owned foreign subsidiaries there. However, these measures had had no secure constitutional foundation, as the 1977 Constitution of the Soviet Union, then in force, recognised only state and collective ownership of the means of production and forbade the use of personal property to derive "unearned income", a term understood to refer to profits and dividends.[15]

A legal basis for private economic activity, including that of domestic and foreign investors, was provided in December 1993 by the new ***Constitution of the Russian Federation***, which explicitly guarantees economic rights, including those of entrepreneurial activity and of private property ownership.[16] Economic reforms, including the privatisation of state assets, had already been initiated, largely on the basis of presidential decrees. (The privatisation programme was published in October 1991 and the voucher privatisation scheme was implemented a year later. By the end of 1993, over 85 per cent of small enterprises and one-third of state-owned enterprises had been privatised. By mid-1994, two-thirds of large and medium-sized enterprises were in private hands.) The 1993 Constitution provides the basis for subsequent economic legislation relating to foreign investment.

The 1993 Constitution was followed by the adoption of a new ***Civil Code***, part one of which came into force in 1995 and part two in 1996.[17] The Civil Code specifies in detail the forms of economic partnerships and companies

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that can be formed in the Russian Federation and, together with part three of the Code which came into force in March 2002, further underlines the property rights listed in the Constitution.

The Law on Foreign Investment in the Russian Federation

In July 1999 President Yeltsin signed a ***Law on Foreign Investment in the Russian Federation***.[18] This law assembles a wide array of rights that had already been guaranteed by diverse separate measures; its intention is to underline the government's commitment rather than to add new rights. The 1999 law guarantees that a foreign investor may make investments in the Russian Federation in any form not prohibited by law[19] and confirms national treatment for foreign investors.[20] The property of a foreign investor or an organisation with foreign investment may only be nationalised or requisitioned in accordance with federal laws or treaties; compensation must be paid for seized property of a foreign investor.[21] Foreign investors have the right to transfer out of Russia without limitation all income and profits of their investments, including profits, dividends, interest, other income, and money received from the liquidation of a foreign-invested enterprise, after paying all taxes and charges.[22] The law confirms the right of foreign investors to purchase securities of all kinds,[23] to participate in privatisations of state or local government property[24] and to acquire land and buildings.[25]

Article 9 of the Law on Foreign Investment provides guarantees to foreign investors and companies with foreign investment against unfavourable changes in legislation. This ***grandfather clause*** protects foreign-invested enterprises against changes that are likely to increase the cumulative tax burden, such as changes in tax or customs duty rates. The application of this provision is limited to companies in which the foreign investor interest constitutes more than 25 per cent of the charter (joint stock) capital and to companies with foreign investment that are implementing priority investment projects, regardless of the proportion of foreign investor interest to the total capital. Such protection is limited to a period of seven years from the beginning of the funding of the project with foreign investment, except in the case of priority investment projects in manufacturing, transport or infrastructure with foreign investment of at least 1 billion roubles, with a recoupment period exceeding seven years. In such cases, the federal government has discretion to extent the term of protection beyond seven years.

Improving access of foreign investors to privatisations of state assets

The ***privatisation policy*** was initially geared to giving certain categories of potential domestic shareholders – employees, management and certain Russian banks and financial groups – clear preference, and foreign investors were effectively excluded from most large sales. More recently, however, the government has moved to a system of auctions and tenders in which all participants are supposed to have an equal chance of securing the asset for sale. But although Russian legislation now enshrines free access and national treatment for foreign investors, many instances of discriminatory or unfair treatment of foreign investors in the implementation of privatisation projects have been alleged. Moreover, the unresolved status of some past, controversial privatisations – occasionally even raising the spectre of re-nationalisation – remains a deterrent for foreign investors, who have instead resorted to joint ventures, direct acquisition from management or stock market purchases to establish a commercial base in Russia.

A new privatisation law came into force in July 2002 which aimed to resolve long-standing conflicts between the executive and the legislative branches of government in matters of disposal of state property. The new law allocates responsibility to the President for designation of strategic enterprises and categories of state assets excluded from privatisation. Responsibility for privatisation of large natural monopolies such as Gazprom, UES and the railways was assigned to the Federation Council, requiring the enactment of separate laws, while jurisdiction for all other federal property was given to the government. The privatisation policies for municipal and regional property were left to the corresponding levels of sub-federal authorities. The new law also introduces a variety of new privatisation methods intended to assist the government in cost reduction and elimination of illiquid assets.

Foreign exchange liberalisation

Awaiting the entry into force of a new ***Foreign Exchange Law*** adopted in December 2003, which has been in preparation for several years, a number of separate amendments have been made to the 1992 Foreign Exchange Law, partly in response to repeated complaints from the foreign business community. For a number of capital account transactions requirements for authorisation have been replaced by a notification requirement only. These include the raising of loans abroad by resident non-financial institutions with a maturity exceeding 180 days and the opening of accounts abroad by resident legal entities to service their representative offices and branches abroad. The mandatory surrender requirement for foreign currency revenue was lowered from 50 per cent to 30 per cent in July 2003. Measures were also taken to liberalise the export of currency out of Russia, so that since February 2003 both Russian and foreign citizens have been allowed to export the equivalent of USD 10 000 without supporting documentation.

The new foreign exchange legislation, effective from 18 June 2004, envisages that several controls (including requirements for repatriation and obligatory conversion) will remain in effect until end-2006, as will the new CBR discretionary power to impose deposit requirements set for a range of capital account operations deemed to have a potentially destabilising effect on the financial sector and the economy in general. Detailed implementing regulations for the new law are currently being drafted.

2.2. The protection of land ownership rights

Russia's new ***Land Code***, passed in October 2001,[26] establishes under law and sanctions land ownership, providing domestic and foreign investors alike with new rights and opportunities. Full provisions of the Land Code apply primarily to urban areas. The Land Code endows the Russian State, municipalities, private individuals and legal entities with full rights to land ownership. Although the law stipulates that perpetual or indefinite use of land[27] is to be granted only to the State and municipal enterprises and authorities, individuals and legal entities enjoy all other forms of land rights covered by the law, including free fixed-term use, leasing, and lifelong heritable possession.

Owners of existing facilities and structures located on land owned by third parties are given the pre-emptive right by the Land Code to purchase or lease the land plot beneath their buildings. The Land Code establishes a formula to calculate the price at which the owners of existing buildings or structures may purchase the land the building stands on. The formula is based on the size of the plot, the land tax rate, the purpose for which the buildings and the land are used, and two other coefficients. The resulting price is normally rather attractive and serves as an encouragement for building owners to establish widespread private ownership of land. In the case of privatisation of buildings and structures by the state or municipal authorities, the law requires that those facilities are privatised together with the land they are upon.

The new Land Code also elaborates on two different procedures for land allocation for construction purposes. In urban areas, the right to purchase or lease land is granted on the basis of public tenders organised by state or municipal authorities. In rural areas, investors wishing to purchase or lease land to be used for the construction of industrial facilities must: *i)* make a specific request for the land rights to the State or municipal authority; and *ii)* consent to a thorough study of ecological, sanitation, architectural and other issues.

A Law ***On the Circulation of Agricultural Lands***, passed in mid-2002, elaborates procedures on the possession, use of, and disposal of land designated for agricultural use, as well as the conditions for the release of such lands from state and municipal ownership and its return to state or municipal ownership. According to the Russian Federal Land Register Service, in 2002 a total of 427.8 million hectares of land in the Russian Federation was designated for agricultural use, of which about 70 per cent is in state ownership and is leased to legal entities or private individuals The new law affects a large part of this surface. Not all agricultural land is covered by the law. Individual land plots for the construction of homes and small-scale or dacha gardening, certain plots of agricultural land with buildings, structures or facilities on them, and urban land zoned off for agricultural use are instead covered by the Land Code.

Foreign nationals, foreign legal entities, and stateless persons are forbidden by law from owning agricultural land. This restriction also extends to Russian legal entities with majority foreign capital participation. Non-residents and foreign legal entities can hold agricultural land on lease, for periods up to 49 years. This provision is understood to apply to all lessees.

While this law is generally seen as a positive reform, laying the legal basis for land transfer and signalling government support for the development of private agricultural land ownership, it does not address all legal inconsistencies and clarify all procedures regarding land transfer. For example, the 1998 Law "Concerning Mortgages (Pledges of Immovable Property)" imposes a ban on pledges of land used by agricultural organisations, farming enterprises and private farmlands that may be held in state or municipal ownership or by private individuals and legal entities.[28] The provisions regarding the transfer of land shares that resulted from the restructuring and privatisation of collective and state farms in the early 1990s and that represent nearly two thirds of total farmland in Russia also need to be clarified.

2.3. The development of corporate governance standards

The 2001 OECD study "The Investment Environment in the Russian Federation" raised several warning flags regarding corporate governance. It concluded that the investment climate was impaired by serious abuses, such as infringements of minority shareholder rights, opacity regarding trusteeship, contradictory regulations in joint stock company law, as well as outright corporate racketeering. Since then, the Russian authorities have undertaken important steps to enhance corporate governance, including in partnership with the OECD.

The Russian Corporate Governance Roundtable was established in 1999. Several meetings have been organised since, bringing together an informal network of Russian and international policy-makers and private sector decision-makers. The OECD Principles of Corporate Governance (see Box 2.1) serve as a benchmark for the Roundtable, providing a set of shared values against which to assess progress in corporate governance reform.

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Box 2.1. **The OECD Principles of Corporate Governance**

The OECD Principles of Corporate Governance ("the Principles"), first published in 1999, cover six main areas. They call on governments to have in place an effective institutional and legal framework to support good corporate governance practices (Chapter I). They call for a corporate governance framework that protects and facilitates the exercise of shareholders' rights (Chapter II). They also strongly support the equal treatment of all shareholders, including minority and foreign shareholders (Chapter III). They recognise the importance of the role of stakeholders in corporate governance, while they also look at the importance of timely, accurate and transparent disclosure mechanisms (Chapter IV and V, respectively). They deal with board structures, responsibilities and procedures (Chapter VI).

The OECD Principles of Corporate Governance have been widely adopted as a benchmark both in OECD countries and elsewhere. They are used as one of 12 key standards by the Financial Stability Forum for ensuring international financial stability and by the World Bank in its work to improve corporate governance in emerging markets.

The Principles are a living document that was most recently revised in 2004. Corporate scandals in a number of countries had highlighted a need for improvements in standards of corporate governance. New provisions address a stronger role for shareholders, conflicts of interest and self-dealing, abuse of related companies, the role of stakeholders, executive and director remuneration, financial market integrity and transparency and effective enforcement.

The Principles are useful not only for discussing the quality of corporate governance in OECD member countries. The Organisation works closely with a large number of developing and emerging market countries. In particular, the OECD is organising Regional Corporate Governance Roundtables in Asia, Latin America, Eurasia, Southeast Europe and, notably, Russia. These Roundtables have used the OECD Principles to formulate regional reform priorities and are now actively engaged in implementing these recommendations.

On the basis of the discussions at the Roundtables, national or regional "White Papers" are produced, identifying common policy objectives and reform priorities with a view to concrete steps that can be taken to improve corporate governance. A White Paper is a non-binding, consultative document, developed on a consensual basis by an informal, but highly influential group of policy makers, regulators, market participants and other experts.

The Russian Corporate Governance Roundtable produced its White Paper on Corporate Governance in 2002, outlining common objectives for reform. Some of the priority areas agreed in the Paper were: *i)* implementation and enforcement of legal and regulatory frameworks; *ii)* clarity and coherence between institutions and legal and regulatory provisions; *iii)* the development of a corporate governance culture; *iv)* continuing support and review of progress; and *v)* the development of training programmes.

A major step forward came in April 2002 with the development of a new ***Code of Corporate Governance*** based on the OECD Principles of Corporate Governance. Although compliance with the Code is not a legal requirement, it provides a clear set of benchmarks for Russian business to follow. Many large companies have adopted the Code and are actively promoting it among their peers. In addition, the Code is effectively mandatory for companies seeking level-one listings in Russia, as stock exchanges have also introduced tougher disclosure requirements and have included compliance with the Code as an obligatory element of such listings. The Moscow Interbank Currency Exchange (MICEX, which operates a stock exchange), which adopted the Code of Corporate Governance in early 2003, demands that companies who want an A1-level listing adopt the Corporate Governance Code, and that those applying for an A2-level listing follow the principles of information disclosure declared in the Code. Similarly, the RTS[29] Stock Exchange, also in Moscow, imposes a requirement that a company seeking to obtain an A-level listing must comply with the requirements set out in the Code. The work on the Code is seen as paralleling and reinforcing the White Paper exercise.

Consistent with the recent revision of the OECD Principles, a revised version of the Code was approved in April 2004. It includes new provisions addressing issues involving institutional investors, shareholder rights, conflicts of interest and auditor responsibility, stakeholder rights and whistle-blower protection, and board duties and responsibilities.

The Roundtable has now moved into a second phase of implementation and enforcement. Policy-makers and business practitioners from Russia and OECD countries launched on 2-3 October 2003 in Moscow two Task Forces for this. One of these ("Task Force I") will assess the experience in introducing international financial reporting standards (IFRS) in Russia. The second ("Task Force II") will assess the present legal, regulatory and institutional framework for related party transactions and beneficial ownership and control.

On the specifics of the task of Task Force I, the Russian White Paper on Corporate Governance recommends a full and quick adoption of IFRS for listed and widely held non-listed companies as a critical ingredient for improving transparency. Recent efforts to speed up the transition to IFRS are an encouraging signal to investors. In 2002, the government announced its plan to speed up the transition process for consolidated reporting of listed companies and financial statements of banks starting in 2004. Difficulties in forming a consolidated and coordinated action plan, as well as the lack of an appropriate legal framework, have resulted in delays. Current efforts by the Governments to draft a Law "On Consolidated Reporting" could provide some leverage to develop further a mechanism for implementing standards and determining priorities. Using IFRS would significantly improve the ability of investors and managers to monitor a company by providing increased reliability and comparability of reporting, as well as improved insight into company performance.

Task Force I last met on 25 March 2004. A summary of the discussions is available on the OECD internet site. The final results will address policy aspects that could assist current efforts to form a consensus on the way forward and will be presented at the end of 2004. The European Union's experience with transition to IFRS will be valuable. This initiative is part of the Russian Corporate Governance Roundtable's second phase of work, focused on implementation and enforcement. It is also a response to a request by the FSFM and the Ministry of Economic Development and Trade for the OECD to support the transition to IFRS, which it considers a priority for improving the transparency of financial markets.

The adoption of high quality financial reporting standards is also essential for Russian companies who want to lower the cost of financing, both nationally and internationally, as well as for the sound corporate governance of enterprises. To the immediate costs relating to the need for parallel reporting by both the financial and real sectors as long as RAS remain closely linked to tax reporting requirements should be added costs of a longer-term nature for hiring specialised staff, retraining accountants and auditors as well as costs inherent in the enforcement mechanism to be instituted. See discussion papers produced for the Consultative Meeting of the Russian Corporate Governance Roundtable held at OECD 25 March 2004 ("Implementation of International Financial Reporting Standards", Task Force I).

The ***Law on Joint Stock Companies*** was amended in 2001 and became effective on 1 January 2002.[30] Further amendments to the Law on Joint Stock Companies were introduced on 31 October 2002 and became effective on 1 January 2003. The amendments provide stronger protection of shareholder rights upon the distribution of issued securities. All shareholders of the company are given a preferential right to acquire additional shares and issued securities convertible into shares which are distributed in an open subscription. Shareholders of the company who voted against or did not take part in a vote on a distribution by a closed subscription of securities still have a preferential right to acquire those shares and securities convertible into shares.[31]

The amendments also provide for stricter rules concerning the increase of registered capital by placement of additional shares, open subscription of additional shares and reorganisation of joint stock companies. A decision to increase the registered capital by placing additional shares through a closed placement, or through an open placement of shares in an amount exceeding 25 per cent of already-placed shares may, depending upon the wording of the company's charter, be approved either by unanimous board decision or by simple majority shareholder vote.[32] However, the increase of a company's authorised capital by the issuance of additional shares, in case of the existence of a block of shares representing over 25 per cent of the votes at the general shareholders' meeting and fixed in accordance with the Russian Federation legal acts on privatisation of state or municipal property, may be carried out during the stipulated period only if the share of the state or a municipal entity remains unchanged as a result of such increase.[33] The decision to amend the Articles of Association concerning an increase of registered capital must be adopted by no less than a two-thirds majority vote of the Board of Directors. Previously, such decisions had to be approved by a simple majority vote of the Board of Directors.

Preferred shares remain limited to a maximum of 25 per cent of the chartered capital.[34] Holders of preferred shares have no ordinary voting rights except in cases provided for in the law, such as reorganisation or liquidation of the company.[35] The law also eliminated a pre-existing clause that allowed for granting the right to vote at an ordinary shareholders' meeting to the holders of preferred shares in the Articles of Association. The amendments to the law also stipulate that in the event of the reorganisation of the joint-stock company by split-up or split-off the shareholders who were not present or voted against the reorganisation have a right to acquire shares in each company in proportion to their current holdings.[36]

In order to minimise violations of the governance of companies that have previously led to important corporate changes without the consent of the shareholders, amendments to the law also provide more detailed rules on the procedures for calling and conducting a General Meeting of Shareholders, covering such matters as notification periods, which were previously the basis for serious shareholder abuse.[37] Another provision elaborated in the amendments concerns the register of the shareholders of the company. While the original law required all joint stock companies to maintain a register of its shareholders, the 2001 amendments make it mandatory for companies with more than 50 shareholders to transfer their registries to a professional registrar licensed by the Federal Service for the Financial Markets (formerly the Commission for the Securities Market or FCSM).[38]

Other changes introduced in 2002 and 2003 include:

- *Large transactions*. Approval rules have been broadened to apply also to loans, credits, pledges and warranties, which is a positive development as regards related party transactions.
- *Specifically related party transactions*. The law now includes as related parties those who issue instructions, which implicitly includes local authorities.
- *The role of the board*. Election of boards of directors must be done by cumulative voting regardless of the number of shareholders. Previously, this provision was restricted to companies with 1 000 shareholders.
- *Terminating authority*. Shareholders are now allowed to terminate the authority of management and the boards of directors at any time, thus significantly increasing their monitoring ability.[39]

Concerning the disclosure of information, regulations have developed over time which require disclosure in various contexts of such documents as accounting documents, minutes of General Shareholders' meetings, minutes of the meetings of the Board of Directors and of the internal auditors, as well as the reports of independent valuers and lists of affiliates of companies. These requirements have been reflected also in the JSC Law,[40] as have provisions relating to compulsory disclosure of information by a company and information concerning the affiliated entities of a company.[41] The FSFM is responsible for monitoring and enforcing the disclosure rules. In 1999, the Federal Law "Concerning Investor Protection" gave the then-FCSM authority to fine joint stock companies and their managers for violating information disclosure rules.

The Federal Law "Concerning the Securities Market"[42] and numerous regulations by the Ministry of Finance and the FSFM require additional disclosure about publicly-listed companies and the securities they issue. The Federal Law "Concerning the Securities Market" states that issues must be registered with the FSFM (or with the CBR, for banks). The requirements for the prospectus include the issuer's financial statements, information on its activities and managers, description of the issue, investment goals, and the list of exchanges where the issue can be traded. New requirements introduced by the 2002 amendments to the Law on the Securities Market include much broader disclosure requirements for closed subscriptions, and much more detailed requirements regarding the prospectus, as well as an obligation to provide interested parties with unrestricted access to information included in the prospectus. A new amendment requires issuers to provide financial statements for the preceding five, instead of three, years.

The amended law also introduces the concept of financial consultant.[43] For public placement and circulation of securities, issuers must hire financial consultants who then are required to sign the prospectus and are liable for the accuracy of the information in that prospectus. Financial consultants must be

FSFM-licensed brokers or dealers in the securities markets. They must not be affiliated with the issuing company and must abide by the FSFM rules regarding the conflict of interest and the use of information obtained as a result of their activity as financial consultants. A detailed list of requirements for financial consultants is available in the FCSM-issued regulation No. 03-30, "*Concerning the Standards of Securities Issuance and the Registration of Securities Prospectus*", dated 18 June 2003.

2.4. The relationship between federal and sub-federal policies towards FDI

Improving federal-regional policy implementation coherence

Administrative obstacles to foreign investment activity are encountered most frequently at the level of sub-federal administrations, often in direct contradiction to federal legislation. There are numerous reports of instances where local or regional governments have imposed unforeseen licensing or permit requirements, or imposed licensing fees in excess of those legally permitted. Regional licensing procedures may differ from federal requirements, and/or may be used to favour local enterprises to the detriment of outside investors. Conversely, grants of federal licences may be hampered by existing disputes between federal authorities and a given region – concrete examples may be found in the field of subsoil licences issued to companies within a particular region, which were revoked to "punish" a region for taking a stand against the federal authorities (subsoil licence issuance requires joint approval by federal and regional authorities). Arbitrariness of this kind sends a strong negative signal to potential foreign investors. Moreover, it is difficult to challenge, since the conditions for approval or denial of a licence are often opaque.

There has been major progress in ***harmonising diverging legislation and conflicting regulation among federal, regional and local agencies***. The Putin administration has been conducting a campaign to assert and strengthen its powers and reinforce the foundations of a single economic and legal space throughout the Russian Federation. In 2000 it restructured the Federal Council (the Upper Chamber of the Federal Assembly) to remove direct representation by regional governors and reassigned regional presidential representatives to seven major supra-regional districts (okrugs).[44] These new presidential representatives were given the general task of co-ordinating federal relations with the 89 subjects and ensuring that central government policies are implemented consistently, with the specific initial assignment of weeding out acts by the executive authorities of the regions that contradict the Constitution, Federal laws, and international obligations of the Federation or violate citizens' rights and freedoms.

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This task has met with considerable success and has been largely completed. In 2000, an estimated 30 per cent of all regional laws and regulations were in conflict with federal laws, mostly in spheres such as regulation of state administration, the constitutional system and financial and business activities. Over 4 000 existing subfederal regulations have since been brought into line with federal laws. The Ministry of Justice, through its 86 territorial agencies, maintains a register which now encompasses 116 000 laws and regulations effective in subjects of the Federation.

2.5. Increasing transparency in the tax system

Investors in the 1990s were confronted with a multiplicity both of taxes and of methods of determining the tax base. Many structural aspects of the system contained an inherent bias against business activity, and its negative impact on entrepreneurs, both domestic and foreign, was aggravated by frequent changes in rules and regulations.

Following attempts at *ad hoc* tax reform between 1993 and 1996, a complete overhaul of the system of local, regional and federal tax legislation, starting in 1998, has produced a more efficient and user-friendly system for both the taxpayer and the collecting authorities. The centrepiece is a Tax Code, which is intended gradually to incorporate the entire legislative framework for the tax system, including rules of calculation and payment of all federal, regional and local taxes. The Tax Code now takes precedence over all other tax regulations.

Part I of the Tax Code, which took effect on 1 January 1999, established the general taxation framework in terms of principles of taxation, definitions and tax administration procedures, including protection of taxpayer rights against retroactive tax legislation and liability for tax violations. Part II of the Code, establishing the rule for calculation and payment of individual taxes, came into force on 1 January 2001, initially containing four chapters dealing with VAT, excise tax, individual income tax and a new unified social tax. Under the VAT Chapter of the Tax Code, VAT remained at its previous rate of 20 per cent but the number of privileged taxpayers was reduced and the recovery of VAT was permitted in full on constructed fixed assets, which reduced the cost of capital investment.

Under the Individual Income Tax Chapter of the Tax Code, the rate of the tax was cut to 13 per cent for residents and 30 per cent for non-residents. The new unified social tax replaced several separate social charges together previously amounting to 38.5 per cent of payroll expense. The aggregate rate of the social charges was lowered. A major portion of the unified social tax is still in effect allocated to the State Pension Fund.

From 1 January 2002 the chapter on corporate income tax ("profits tax"), applying also to banks and other financial institutions, came into force, setting a flat profit tax of 24 per cent for all enterprises, split among federal, regional and local authorities. It also eliminated the previously widespread use of tax concessions and special favourable tax regimes at all levels of government. Finally, it introduced a liberal withholding tax regime for Russian-source income of foreign companies.

Expense deduction rules were broadened from January 2002 to permit full deductibility of most major business expenses. Remaining restrictions on the deductibility of certain expenses are largely similar to expense deductibility restrictions in many industrialised countries. Before 2002, the tax base for Russian corporate profits tax was larger than the comparable corporate tax base in other industrialised countries because of restrictions on the deductibility of some business expenses, often resulting in a higher effective profits tax rate than the nominal statutory rate would suggest, especially since many of the expenses subject to restricted deductibility were the principal expenses incurred by businesses in the transition from a command economy to a market economy.

Part II of the Tax Code now includes thirteen chapters on individual federal tax. The Tax Code will be further expanded by the addition of a new chapter on the regional property tax, with the new chapters on the remaining federal, regional and local taxes to follow within the next few years.

Tax incentives for FDI appear of less importance in the recent period, except at local levels. Efforts to contain them and make them available to all investors are compatible with positions taken by the OECD Investment Committee [see *OECD Checklist on Foreign Direct Incentive Policies* (*www.oecd.org/daf/investment*)]. It is important that measures to reduce reliance on special tax incentives be conceived as part of a broader reform effort to establish a broad-based, fair and transparent tax regime for investment, whether foreign or domestic.

2.6. Improving public governance

Cutting red tape

The issue of ***administrative reform*** is a pressing one in the current economic context in Russia, and a major programme has been under way since 2002 to reform the operations and powers of government agencies and municipal self-governing bodies. The capacity constraints and inefficiency under which the national government operates due to its competing and overlapping structures with unclear accountability make it unable to promote and implement effective policies conducive to economic growth. For investors, the most immediate negative aspect of the Russian business environment originates from an overly complex administrative system, which has resulted from the merger of an ever-growing body of new, modernised laws and regulations with remnants of Soviet administrative practices. In addition, the

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combination of inadequate training and low salaries of officials at all levels who administer these laws and regulations has generated corruption and rent seeking on an enormous scale. Administrative barriers and direct "corruption taxes" levied by the officials in charge of licensing, inspections and other authorisations have severely curtailed entrepreneurial activity, especially at SME level where the means of protection may be unaffordable. It was suggested in the 2001 OECD study that foreign investors were frequently singled out as targets of harassment via arbitrary additional licensing and product certification requirements, usually at the level of sub-federal administrations.

The Russian authorities are well aware of these shortcomings, and have recently implemented reforms aiming to reduce administrative barriers and rent-seeking opportunities. A federal government programme of ***de-bureaucratisation*** was launched in 2001. A central goal of this reform is to slash multiple registration, licensing and inspection procedures. New legislation related to these procedures as well as to certification has been welcomed by both foreign and domestic investors.

The "Law on Protection of Legal Persons and Individual Entrepreneurs in the Process of Exercising State Control (Supervision)" was enacted in 2001, with the purpose of ***reducing the number of inspections to which businesses are subjected***. It defines procedures for government inspections and assigns responsibility to government agencies carrying out the inspections. The law stipulates the procedures for unplanned inspections but does not limit their frequency. It also prescribes the duration of an inspection, which should not exceed one month, or, in special cases, two months.

The Law "On Licensing of Certain Activities" came into effect in February 2002. It strictly limits ***the number of activities subject to licensing*** and reduces the fee for obtaining a licence to 1 000 roubles, plus 300 roubles for application, and stipulates that the licence should be valid for not less than five years.

The Law "On State Registration of Legal Persons" (July 2002) limits the charge for registration of an enterprise to 2 000 roubles and the time limit for approving or rejecting registration applications to no more than a month after submission. The law also establishes the goal of having a single office complete the registrations process. According to the Russian Foreign Investment Law, registration should take place with the "bodies of justice", but the State Registration Chamber, attached to the Ministry of Justice, only provides guidelines as to which types of enterprises need to be registered, leaving the registration process largely to be administered by regional authorities.

A new Law "On Technical Regulation" introduced in December 2002 provides for a seven-year period of transition to completely ***new procedures of standardisation and certification*** and requires the adoption of a number of new sectoral sublaws in order to be fully implemented. The law provides for public consultation through publication, also in electronic form, so that all interested parties should thus be given access to draft technical regulations and a possibility of providing comments before finalisation and introduction of new regulations.

Regular monitoring of administrative barriers to business development in Russia is carried out by the Russian Centre for Economic and Financial Research (CEFIR).[45] CEFIR survey results indicate some improvement in that the number of inspections has declined, but "ïllegitimate" licensing requirements are still reported and in some regions the number of inspections has actually increased. The second round of business surveys found improved perceptions of the business climate, but 44 per cent of the population surveyed still reported problems with business registration, licensing and permits, price control, certification or documentation requirements. The administrative burden on the enterprise sector in terms of filings required and the number of state organs exercising some measure of (frequently overlapping) control has not been greatly reduced. The removal of unnecessary barriers at federal level has not yet been completed, nor has there been full implementation of de-bureaucratisation at regional level.

Improved Bankruptcy Law

A new ***Bankruptcy Law*** was passed in 2002, eliminating the deficiencies in the previous Bankruptcy Law which made it a vehicle for fraudulent asset transfers and predatory take-overs rather than an instrument for promoting the orderly restructuring of distressed enterprises. The previous bias in favour of creditors, which made these abuses possible, has been removed by making it more difficult to initiate a bankruptcy process and by providing the debtor with better possibilities of settling or restructuring overdue obligations. The new law also removes the state's priority claim in the hierarchy of creditors and strengthens the rights of secured creditors more in line with international practice. It now covers other sectors of the economy, such as agriculture, the defence industry, one company towns, securities market activities and insurance, which were excluded from the coverage of the old law. While these are major improvements, there is still scope for misuse of court injunctions in corporate conflicts. By bringing in greater reliance on rehabilitation as opposed to liquidation, the new version of the Bankruptcy Law unwisely transfers too many powers in this area to courts rather than temporary administrators, in view of the courts' poor record of competence and ability to withstand pressure from local and regional administrations.

A ***new Customs Code***, effective from 1 January 2004, has simplified customs clearance procedures and will therefore increase handling speed, cut storage and transport costs and improve the financial performance of investment projects. In addition to being tailored to generally accepted international norms and practices it will provide an adequate legal basis for qualitative improvements in the Russian customs administration, changing its priorities from focusing on its fiscal function to that of promoting foreign trade. The new code also addresses problem areas for foreign investors, including the variable application of customs regulations between regions. While authority over customs regulation generally falls to the federal government, regional authorities have had responsibility for classifying goods, estimating their values and defining their country of origin, allowing considerable latitude for abuse.

2.7. Developing an effective and independent court system

Recent efforts to ***strengthen law enforcement*** include a major overhaul of the judiciary, completed in 2002, consisting of laws and amendment to laws relating to court procedures, the status of judges and the status of attorneys. It also included significant salary increases for judges and a strengthening of the court infrastructure.

In this package, major immediate benefits for investors were brought through the enactment of the ***Russian Federation Code of Arbitrazh Procedure*** in September 2002 and the ***Russian Federation Code of Civil Procedure*** in February 2003. These Codes brought all disputes concerning corporate relationships under the jurisdiction of a single body, the Arbitrazh Courts, with the aim of ending previous abuse by physical persons (shareholders) of their right to take commercial disputes to courts of general jurisdiction. Corporations had previously found it difficult to protect themselves against frivolous law suits brought in a parallel court system to disrupt or delay justice. The procedural code for the Arbitrazh Courts is designed to encourage amicable dispute resolution, including out-of-court conciliation. Arbitrazh Courts have also been made responsible for the recognition and enforcement of international arbitration awards.

3. Removing remaining obstacles to FDI

Despite the improvements in the investment climate noted in the previous section, obstacles to FDI persist. This section examines remaining restrictions, explains why they are dysfunctional for the Russian economy and proposes policy options to relax them. The policy challenges include directly discriminatory measures as well as non-discriminatory obstacles which affect both domestic and foreign investment (*e.g.* the foreign exchange regime, corporate governance, competition policy, national-local policy coherence, administrative reform and corruption).

3.1. Relaxing remaining formal restrictions on foreign ownership

The financial sector

The Russian financial crisis which followed the sharp devaluation of the rouble and the government's *de facto* default on its domestic debt in August 1998 brought into focus the weakness in banking supervision and the legal environment in which banks and other financial institutions were operating. Cross-ownership relations producing a "captive" status of many banks within industrial holding groups, weak security for investors' rights, disclosure deficiencies and lack of market transparency as well as generally low standards of corporate governance all contribute to reducing investor confidence, thus slowing down the development of fully efficient markets and institutions.

The Russian authorities are now confronted with a number of important policy challenges relating to further development of financial-sector infrastructure and regulation: full liberalisation of capital account operations, the development of a funded pension system, the liberalisation of financial services within the framework of GATS negotiations (notably in banking and insurance) and the implementation of the new deposit insurance system requiring the eventual inclusion of the dominant state-owned Sberbank and the elimination of weak and undercapitalised institutions.

The Russian authorities are well aware of the need to adopt an integrated approach in addressing the challenges of achieving efficient economy-wide financial intermediation. Over the past ten-year period, different departments and agencies have been charged with producing laws and regulations for the development of different segments of the financial sector, with limited opportunities for co-ordination, sometimes leading to parallelism of functions and contradictions in regulation – as well as costly red tape for market participants. Since end-2003, there has been a better co-ordinated and integrated approach. A concrete sign of this new strategy is the recently announced creation of a Federal Service for the Financial Markets (FSFM), which may eventually assume all the function of the former Federal Commission for Securities Markets (FCSM), in addition to monitoring the asset allocation of private-sector pension funds, formerly controlled by the Ministry of Finance. The new service will also assume responsibility for regulating the commodity markets from the former Anti-Monopoly Ministry. This goes part of the way to resolving the previous conflicts among different regulatory authorities which have bedevilled attempts to develop the non-bank financial sector.

Against this background, the maintenance of ceilings on the ***participation by foreign investors in the banking and insurance sectors*** do not seem appropriate and in the interest of the development of a robust financial sector. Statements by senior Russian officials in the context of GATS negotiations indicate preparedness on the part of the authorities to impose a limit of 25 per

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cent on foreign participation in the banking sector. In addition, amendments to the *Law on Organisation of Insurance Activity*[46] adopted by the Duma in December 2004 taking effect on 17 January 2004[47] raise the maximum stake of foreign insurers in the total equity capital of Russian insurers from 15 to 25 per cent.[48] In addition, restrictions on foreign firms' operations in the spheres of compulsory insurance and life insurance are lifted for insurers originating from EU member states, but not for those from other countries. The authorities maintain that the limits imposed have not represented any binding constraint as foreign interest in the sector has so far not materialised to the extent of filling any quota.[49] However, the persistence of these restrictive measures discourages the inflow of foreign capital and expertise into a sector where further development should be an urgent priority.

Fuel and energy

As the main driver of economic growth in the Russian economy, the energy sector remains a major focus of both foreign direct and portfolio investment. However, foreign investors are still hampered by Russia's inefficient regulatory approvals process that involves multiple major and minor approvals from federal, regional and local agencies. Additionally, there still exist a number of important inconsistencies in pricing in the gas sector that impedes foreign investment in both the gas and electricity sectors. Mineral resource extraction in Russia is governed by the 1992 Law on the Subsoil.[50] Proposed changes to the 1992 Law on the Subsoil, including a draft Subsoil Code, do not appear likely to effect major improvements in the current licensing regime for mineral resource extraction. Their main effect may be to redistribute some measure of control of subsoil resources to the federal government and to promote licensing as the primary form of subsoil usage. Tenders for such licences are open to both domestic and foreign bidders. Licences for subsoil use may be transferred where provided for by existing legislation, but the right of ownership of a licence is not a freely transferable commodity. The transfer procedure is simpler if the licence is being transferred to an affiliate; in the case of a transfer to a new company, the licence must be returned and then submitted to tender.

Production-sharing agreements (PSAs) have hitherto provided a special legal framework for foreign investors in mineral resource extraction requiring substantial long-term investment in accordance with the 1995 Federal Law on Production-Sharing Agreements.[51] However, recent developments indicate that the government now intends to cease using PSAs, except in the case of a small number of large-scale projects in difficult locations and with small projected returns and for which there are no bidders at auctions for subsoil rights. Existing grandfathered PSA projects will be allowed to continue; however, recent amendments to the Tax Code have affected these negatively. It must be noted that despite some reforms in the hydrocarbons sector since 2001, foreign investors must in practice enter into extensive co-operation agreements or joint ventures with well-connected Russian partners in order to realise their investments.

Following the preparation of several competing proposals for gas sector restructuring which appeared at the end of 2002, potential investors have expressed disappointment at the fact that no decisions have so far been taken. In addition, the plans to liberalise trade in Gazprom's shares by removing the strict separation between the domestic and ADR markets have not yet been implemented. In the sense that Gazprom has been engaging in buy-back of its own shares during 2003, the government has consolidated its direct (38 per cent) and indirect shares into a majority stake. So far, Gazprom is also resisting efforts to move toward a more market-oriented pricing system and reduce the difference between export prices and far lower domestic prices, a practice which is impeding foreign investment in both the gas and electricity sectors.

The ability of the electricity sector to attract foreign investment for new electricity generation capacity is highly dependent on the current regulatory reform process in this sphere, where some progress was made in 2003. However, electricity tariff levels are still set too low by the government to make the sector attractive to foreign investment. Additionally, current government policy affecting both the electricity and gas sectors does not give foreign investors the assurance of secure and stable gas supply at predictable prices which would enable them to conclude long-term, enforceable contracts.

In addition, foreign ownership ceilings remain in force regarding portfolio investment in Gazprom, and in Unified Energy System (UES), the national electricity monopoly. A Presidential Decree[52] issued in 1999 set a 20 per cent cap on ***foreign shareholders' stake in the natural gas monopoly Gazprom and its affiliates***, and raised the government's minimum stake to 35 per cent. Foreigners may buy Gazprom's American Depositary Receipts (ADRs), but another regulation issued in 1997[53] states that Gazprom's domestic shares cannot be freely converted into ADRs. Recently, Gazprom's management has been discussing the removal of the convertibility restriction, but this has not yet happened. Legally, ***foreign ownership in UES*** is limited to 25 per cent and state ownership is set at 51 per cent.[54] However, the real extent of both state and foreign ownership is difficult to calculate as UES shares are freely convertible into ADRs and *vice versa*, and the State is widely reputed to hold over 51 per cent of the company. There has been a push by UES management to eliminate foreign ownership caps as a part of its restructuring programme, but no conclusive decision has been reached yet.

Reciprocity condition in telecommunications

A new ***Communications Law*** was approved in 2003, supplanting the 1995 Law on Communications. Unlike the earlier law, the new law does not explicitly state that foreign ownership of telecommunications facilities is permitted in the Russian Federation,[55] but it does imply this by stating that individually-owned and legal-person ownership is permitted in the sector.[56] It further states that any foreign investor may take part in privatisations of state-run and municipal enterprises' property on terms specified by the Russian Federation laws.[57] However, ***a reciprocity condition*** applies for participation by foreign investors: the new Communications Law stipulates that foreign organisations and citizens shall enjoy a regime established for Russian Federation citizens and institutions to the extent that such a regime is provided by the corresponding country to citizens and organisations of the Russian Federation, unless otherwise stipulated by international treaties or Federal laws of the Russian Federation.[58] Although there have in recent years been attempts to impose a 49 per cent limit on foreign investment in telecommunications enterprises, no such limit has so far been imposed. The Ministry of Information Technology and Communications, formerly the Ministry of Communications and Informatisation, has stated that it does not intend to impose any limit on foreign ownership of mobile telecommunications enterprises.

Long-distance and international telecommunications are routed via lines owned by Rostelecom. The Russian government intends to maintain the monopoly enjoyed by Rostelecom of such services for six years after WTO accession to enable it to cross-subsidise the modernisation and expansion of basic telecommunications infrastructure. In the long term, the government envisages that the lowering of operating costs resulting from the introduction of new technology will allow it to end this practice.

The authorities are considering further privatisation of the federal holding company Svyazinvest which owns seven consolidated regional telecommunications companies that together currently control approximately 80 per cent of the industry (and also 50.7 per cent of the voting shares of Rostelecom), but will only do so when they have found ways of meeting national security concerns without having to introduce restrictions on foreign ownership. The authorities are also considering privatisation of state-owned telecommunications companies and in this context, ways of meeting national security concerns while allowing foreign participation in the privatisation process. Lack of transparency of procedures has a *de facto* discouraging effect on foreign participation in current privatisation programmes.

The licensing process for telecommunications operators is characterised by a lack of transparency and predictability which has not been ameliorated by the amendments to the Communications Law in 2003. The Ministry of Information Technology and Communications (referred to in the Communications Law of 2003 as "the Federal executive authority body in the field of Communications") has substantial discretion to grant licences to telecommunications operators,[59] allowing it to establish different licensing conditions for different operators and to amend or modify licences after they have been granted. However, licences may only be revoked by the Ministry after a court decision confirming transgression of the operating conditions. Although the new law specifies the very wide powers of the Ministry in establishing licensing terms and in issuing, denying, suspending, annulling and reforming licences,[60] and also lays down detailed requirements in terms of licence application procedures,[61] it does not make clear the criteria upon which the decision to issue or deny a licence is based. Allocation of radio frequencies is similarly opaque,[62] and the right to use a particular radio frequency band may not be assigned by one radio frequency spectrum user to another without a decision by the Radio Frequencies Governmental Commission,[63] limiting market allocation of this resource.

3.2. Expediting implementation of the Foreign Exchange Law

As mentioned above, the Russian Central Bank continues to impose restrictions on the outflow of foreign currency to restrain capital flight. Although these restrictions are intended to stem illegal outflows, they may hinder legitimate repatriation of funds by foreign investors.

A major currency control issue is the requirement that a resident of Russia must obtain advance approval from the Ministry of Finance to convert roubles into foreign currency to make one or more related payments of more than USD 10 000 (or the equivalent in another foreign currency) to a non-resident of Russia under a contract for the provision of most services, including an inbound cross-border lease. Advance approval is not required if the Russian resident has sufficient foreign currency funds to make the payment and does not need to convert roubles into foreign currency for that purpose. However, currency conversion requirements may make it difficult for a Russian entity to amass sufficient foreign currency reserves to avoid the approval requirement. Although such approvals are generally granted, there is often a delay of several weeks.

Central Bank or Ministry of Finance approval continues to be required for certain categories of transaction involving foreign currency. As a way of controlling outward and inward capital flows occurring through leads and lags in trade payments, foreign purchasers of goods exported by Russian entities must pay for such goods within 90 days unless they have authorisation from the Ministry of Finance for a longer period. Payment in connection with purchase otherwise of immovable property or shares on a secondary market may be made only pursuant to a prior licence of the Central Bank. Certain set-offs and other settlement arrangements require prior Central Bank approval if they involve foreign currency indebtedness. In addition, the repatriation and surrender requirements imposed for all currency proceeds obtained abroad by residents (with limited exceptions) is still regarded as onerous, even at the lower rate of 30 per cent.

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Each of these requirements, while technically applicable to all entities within Russia, has a disproportionately greater impact on foreign investors and Russian entities which have significant operations with foreign countries and/or foreign shareholders or partners. Moreover, the process of seeking and obtaining Central Bank approvals is cumbersome, document-intensive and very time-consuming. Although licences are usually granted, the process can take several months for a foreign investor who follows proper application procedures.

There are also complex rules and regulations governing the use by foreign investors of domestic bank accounts. A number of regimes are currently in force. Foreign legal entities may conduct most of the operations either through "K" (convertible) or through "N" (non-convertible) accounts. Roubles deposited in a type "K" account may be freely converted into foreign currency. Amounts credited to a type "N" account may be converted into foreign currency only if they are deposited for one year. In addition, for certain settlements in connection with securities and other investment operations non-residents may open type "S" accounts, which also have usage and repatriation restrictions. Non-resident individuals may conduct settlements through type "F" accounts.

3.3. Further improvement of corporate governance

Despite the progress highlighted in Section 2, more needs to be done to strengthen requirements for disclosure of ownership and control structures and to establish clear rules concerning mergers and acquisitions. While since 2000, a small number of leading Russian companies have embraced internationally recognised standards for information disclosure and transparency of asset structures, this is still reported to be the exception rather than the norm. Such efforts were often undertaken prior to the launching of major share or bond offerings on international markets, to reassure potential investors and increase the attractiveness of the company. As is observed in Russia, a certain evolutionary process seems to be required from the time of a company's or holding's reorganisation, following privatisation and subsequent takeovers, and the creation of transparent and fully legal asset and ownership structures, when entry to international markets or preparation for a major cross-border transaction become powerful incentives for greater transparency.[64]

The structures of property and control are far from transparent, since Russian companies often use complex cross-holding schemes, including some that operate via one or more "mailbox" offshore companies. The lack of ownership transparency makes it difficult for regulators, supervisors and tax assessors to enforce regulatory requirements. It also prevents outsider shareholders and potential investors from forming a clear picture of the way control is exercised in order to assess their own position and interest in providing finance to a particular company.

The use of screening devices to hide beneficial ownership is not unique to Russia. However, the lack of clarity in the disclosure of ownership and control structures in the general model of corporate governance that has evolved in Russia in the past decade is so pervasive that it has serious implications for many of the checks and balances recently instituted which rely on standards of fair and equal treatment and transparency (antimonopoly legislation, privatisation and other tenders, licensing of financial market participants, etc.). As shown in Section 2, attempts to improve ownership disclosure have recently been made, but a high level of ownership concentration, the closed, non-transparent nature of many companies, amalgamation of functions of management and ownership, the practice of in-house financing and co-opted boards of directors still combine to facilitate disregard of minority shareholder rights in Russia.

The schemes or mechanisms abused by open joint-stock companies and their major shareholders in Russia to conceal and convolute real ownership structures vary greatly. They include cross-holding schemes involving financial institutions (a practice particularly prevalent among but not limited to large financial-industrial groups), acquisition of shares via offshore companies, use of nominee shareholders and entering into shareholder agreements.

One of the most prevalent practices employed to conceal beneficial ownership is the use of nominee shareholders to avoid disclosing offshore companies and trusts as the true holders of a company's capital. However, there are some legal safeguards against such practices. While Russian law does not have a definition of *beneficial ownership* applicable to the stock market, it does make a distinction between the notions of a *nominee shareholder* and the *owner of securities*. In accordance with Article 8 of the Federal Law "On the Stock Market", a nominee shareholder is a person registered with the register keeping system of the company who is not an owner of the stock. However, while the shareholder register contains information on the nominee shareholders, the list of persons entitled to participate in a general shareholder meeting must reflect information on the owners of the stock. The nominee shareholders can thus be required to divulge the information on persons or entities in whose interest they hold the stock.

Federal legislation and FSFM regulations need to be streamlined to establish common norms of information disclosure, and strengthen the enforcement of those norms. Powerful incentives for the disclosure of information at company level now exist, both through mandatory compliance with the Corporate Governance Code enforced by stock exchanges and professional organisations and through the alignment with international standards by those companies that approach international capital markets. The government must reinforce those incentives by underpinning confidence

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in the impartial and consistent enforcement of the law and removing perceived threats of re-examination of past privatisation transactions.

Related party transactions

In Russia as well as in other countries, related party transactions may be on market terms and conducted at arms-length but the fact that they are related involves control which may lead to abuse. In most countries, the definition of related party and related party transaction, as specified under the law, listing requirements, or in accounting standards, varies considerably. In Russia, there has in the past been considerable abuse of minority and other shareholder rights through related party transactions and many suggestions have been made from the international investor community to curb such abuse through stricter regulation including clearer, more inclusive and coherent definitions in the legal and regulatory framework of what constitutes related parties.

The existence of abusive related party transactions is often the result of weaknesses in the corporate governance system and related areas, including the disclosure and access to information about ultimate beneficial ownership and control structures. The Russian Ministry of Economic Development and Trade and the FSFM have requested the OECD to help develop possible policy options – learning from some OECD member country experiences – focused on implementation and enforcement of the policy framework in these areas. The final results will address policy aspects that could assist current efforts and will be presented to the Russian Corporate Governance Roundtable at the end of 2004.

Recent amendments to the Law "On Joint Stock Companies" aim to impose stricter limits by defining as related party transactions those that imply an interest to a company shareholder, who jointly with affiliated persons owns 20 per cent or more of the voting shares of the joint stock company. The shares of these shareholders will be recognised as non-voting during the relevant ballot. However, in practice, such restrictions are often not enforced at shareholder meetings (or evaded through transfers of shares amongst family members) and numerous transfers of assets from subsidiaries to mother companies and *vice versa* have occurred, often to the detriment of minority shareholders.

Anti-monopoly measures

All significant mergers and acquisitions are formally subject to notification from the earliest stages of the transaction. According to Article 18 of the Federal Law "On Competition and Restriction of Monopolistic Activity on Product Markets" an acquisition by a legal or a natural person of more than 20 per cent of the voting shares in the charter capital of a legal entity requires preliminary consent of the antimonopoly authority. In reality, often a number of legal entities are set up to conceal the identity of the true purchasers. The anti-monopoly authority is then contacted after the stake has been purchased by formally independent legal entities to legalise the new ownership structure.

After the recent re-organisation of the government, these functions are performed by the new Federal Antimonopoly Service, which replaces the now-eliminated Anti-Monopoly Ministry. The jurisdiction of the new body will be more closely focused on competition issues, because consumer and utility matters will be done elsewhere.

The changes, which still require new laws and regulations for implementation, are positive steps toward more effective competition policy oversight, which is an important element of a healthy investment climate. They are consistent with the recommendations made in the peer review of Russia's competition law and policy, which was held in the OECD's Global Forum on Competition in February 2004.[65] That report described the efforts of the anti-monopoly agency, through advocacy as well as enforcement, to support reforms and to correct official actions that interfere with trade and competition. It proposed several measures to make the enforcement of the rules of competition more efficient and effective. Some further suggestions for improving anti-monopoly oversight that are directly related to the problem of beneficial ownership include harmonisation of anti-monopoly law and corporate practice, the elaboration of the concept of beneficial ownership and the regulation of activities related to "affiliated parties and *persons*".

3.4. Continuing efforts to ensure compliance with federal laws at sub-federal level

Implementation of land acquisition and usage rights of foreign investors

While the legislative base for the privatisation of urban land has been set, few tenders have so far taken place. One of the impediments to the development of a healthy real-estate market in Russia is the absence of a comprehensive registration framework. There are now in Russia multiple registers of land plots, technical records of buildings, installations and structures. Procedures for recording and identifying various types of real estate are fragmented. There is no unified register of real estate rights, which greatly complicates both the "primary market", *i.e.* the privatisation of State- and municipal-owned lands, and the "secondary market" – the commercial turnover of already privately-held real estate.

In March 2004, the OECD conducted a survey of federal-regional policy coherence in North-West Russia in co-ordination with the North-West

Investment (Development) Agency in St. Petersburg. Experiences and opinions were canvassed from a variety of respondents to a questionnaire and thereafter in a follow-up workshop in St. Petersburg, where participants included officials from the federal government and from the governments of St. Petersburg, Kaliningrad oblast, Leningrad oblast and the Republic of Karelia; representatives from local consulates of several OECD member governments; representatives from chambers of commerce in North-West Russia; representatives of Russian enterprises; and academics specialising in relevant fields of study. The survey found that problems of lack of coherence between federal government policy and the policies implemented at regional level and below are still in evidence, in particular in relation to acquiring real estate for business purposes. It was reported that purchasing land on the secondary market in St. Petersburg, for example, was easier than buying or leasing land owned by the state, but that most land was state-owned. Moreover, it was difficult to find a vacant site on the small secondary market. Procedures for obtaining land were reported to be inconsistent and cumbersome.

3.5. Developing a level playing field for the privatisation of state-owned enterprises

The new law guiding the privatisation of state-owned enterprises (see Section 2) does not lay out a comprehensive strategic vision for how the privatisation process should be pursued. It also does not address the lack of transparency and equity in the implementation of privatisation tenders, which routinely produce seemingly prearranged outcomes. Foreign-owned bidders have complained about the opaqueness of selection processes and that privatisation requirements are often structured in such a way that certain bidders are favoured in practice. While the new law no longer allows the exclusion of bidders unable to submit, as part of the purchase price, a specified asset (since cash contributions must now be considered in lieu of in kind requirements), problems of discrimination are reported to remain.

Even if the foreign investor does win the bid, there may be an increased risk that the privatisation becomes subject to challenge. Because of inconsistencies and contradictions within existing privatisation legislation, it is almost certain that any privatisation will have been conducted in violation of some provision of law. As a result, every privatisation is in theory subject to challenge. Well-publicised privatisations in which a foreign entity (or an entity with foreign investment) prevails may be a more attractive target for such challenge than other, better-connected domestic entities.

3.6. Further improvements in the legal system, tax collection and the fight against corruption

Further improvement in enforcement of court and foreign arbitration judgments

Recent legislative changes are of real benefit to investors, but their implementation and enforcement cannot be fully ensured. The judiciary and its enforcement mechanisms remain weak and suffer from resource constraints, lack of competence, favouritism and corruption, as mentioned in the 2001 study. For foreign investors to feel confident that their rights will be protected, the competence, independence, and probity of judges and enforcement officers need to be further increased. Even if a number of common abuses are now either clearly designated as illegal or have become more complex to perform; legislation *ex post* can not anticipate and close loopholes for other forms of abuse which have not yet become common practice. To do this requires both an efficient system of administration and enforcement of the law and respect by economic agents for the spirit of the law and the basic safeguards that the law is intended to provide.

Judicial recognition and enforcement of foreign arbitral awards remains problematic, at best, with Russian judges frequently relying on the "public policy" exception under the New York Convention to refuse recognition and enforcement. Also troublesome is the significantly expanded list, under the new Code of Arbitrazh Procedure, of subject areas within the exclusive competence of the Arbitrazh Courts and which are thus arguably unarbitrable.

Ensuring consistent and fair implementation of the Tax Code

Although the new Tax Code greatly clarifies the roles and powers of tax inspectors and tax bodies and grants taxpayers greatly expanded rights, tax enforcement remains political and often arbitrary. A practical problem in this area is that tax inspectors have a dual function: they are charged not only with enforcing tax legislation, but also with meeting budgetary targets for tax collection. While this combination of functions is not unusual, the manner in which it is applied in Russia creates an incentive for inspectors to assess additional taxes even when there is no basis for doing so, and creates a disincentive to pay out refunds of withheld or overpaid tax to taxpayers. To ensure that the tax authorities concentrate their efforts on enforcing tax legislation and ensuring taxpayer compliance with its provisions, there needs to be clearer direction on the standards which should be applied to reviews and audits to reduce the discretion of individual inspectors and the imposition of clear sanctions on officials when they assess additional taxes without any reasonable basis and when they fail to pay refunds in a timely fashion.[66]

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Foreign investors have frequently complained of difficulties in obtaining refunds of withheld or overpaid tax. Cases are reported in which the service has either itself recognised an obligation, or has been ordered by a Russian court, to repay an amount, but has refused to do so or has protracted the process with frivolous appeals and additional claims. Where refunds are calculated in roubles, such delays can have a disproportionately severe impact on foreign investors because of currency fluctuation risks. In some cases, taxpayers may claim interest on delayed repayments, which may to some extent compensate for added currency risk. This problem also affects exporters entitled to claim VAT refunds on inputs used in the acquisition and/ or production of exported goods. Taxpayers are rarely able to obtain a refund without lengthy and costly litigation.

In examining shortcomings in tax administration in Russia, it is important to bear in mind that the taxation system was only established in the early 1990s and there has as yet not been sufficient time for administrative approaches to mature. The absence of a taxpaying culture after more than seven decades of Soviet rule, heightened by perceptions that a few people have become disproportionately enriched by the privatisation of state assets, means that there is widespread and persistent resistance to paying tax, leading to large-scale tax evasion, particularly in the area of VAT. The requisite cultural change necessary to permit full implementation of a regular taxation system will take many years to complete.

The fight against corruption

Eradicating corruption would greatly improve the investment climate. Some laws and draft regulations have been developed to fight corruption from the perspective of recipients of illicit payments, but further efforts need to be made to ensure good public governance and prevent, detect and punish corruption. The Russian authorities need to ensure the effective adoption and enforcement of draft laws and regulations aimed at simplifying the administrative process, reducing the scope for administrative discretion and limiting rent-seeking opportunities. Laws should also be further developed to increase public-sector integrity.

Russia formally applied to accede to the OECD Convention and to become a full participant in the OECD Working Group on Bribery in 2000. Russia has since engaged in a dialogue with experts from the Working Group on Bribery and adopted the "Anti-Corruption Action Plan" established in the framework of the OECD's Anti-Corruption Network for Transition Economies (ACN). Russia also signed the United Nations Convention against Corruption in December 2003 and the Council of Europe Criminal Law Convention on corruption in 1999.

To live up to its various international commitments and ensure a level playing field in the conduct of business, Russia still needs to adopt rules and regulations in line with international standards to criminalise bribe-giving to domestic and foreign public officials. Another major challenge is to ensure effective investigation and enforcement of anti-corruption laws and regulations. The widespread perception of a high level of corruption in the judiciary and the enforcement agencies undermines the credibility and effectiveness of the enforcement effort. The Russian authorities might also consider encouraging the private sector to introduce integrity measures, such as corporate codes of conduct and compliance policies, and adopting whistle-blower protection measures to ensure that employees in both the public and private sectors can report suspected bribery without fear of reprisal.

The Russian authorities are encouraged to develop a broadly designed anti-bribery framework which would live up to Russia's domestic and international commitments to fight corruption. The development of legal and regulatory preventive and punitive standards will help improve the investment climate and ensure fair business practices. Regulatory reform and simplification of adminstrative procedures would help reduce opportunities for corruption. Other anti-corruption measures may include increases in official salaries, laws against conflicts of interest, strong independent controls and credible enforcement systems and penalties.

Notes

1. *Investment Policy Review of the Russian Federation*, OECD (2004), forthcoming.
2. *OECD Economic Surveys: Russian Federation*, OECD (2004), Table A1.1.3, forthcoming.
3. Gross savings divided by gross domestic product, FSSS statistics. The figure for 1995 was 25.4 per cent.
4. Plausibly estimated as ranging between USD 10 billion and USD 20 billion in the late 1990s.
5. Fabry and Zeghni (2002).
6. *OECD Economic Surveys: Russian Federation*, OECD (2004), Chapter 2. *Cf.* Tables A2.1.1 and A2.1.2, forthcoming.
7. Yudaeva *et al.* (2001) found that such spill overs were positive from foreign-owned to domestic firms in the same industry, but negative on domestic firms that are domestically related to foreign-owned firms.
8. *OECD Economic Surveys: Russian Federation*, OECD (2004), Chapter 1, forthcoming.
9. *International Investment Perspectives*, OECD (2004).
10. Claessens *et al.* (1998), found prospective EU accession to be a significant determinant of FDI in an econometric evaluation of the factors determining FDI in Central and Eastern Europe and the countries of the Former Soviet Union.

11. FDI inflow statistics diverge between the two official sources in Russia, FSSS and the Central Bank of Russia, mainly because of differing methods of recording and calculation. *Cf.OECD Economic Surveys: Russian Federation*, OECD (2004), forthcoming.
12. Regional statistics are published later than national statistics; at the time of writing, figures for 2003 were not yet available.
13. FSSS figures.
14. *The Investment Environment in the Russian Federation: Laws, Policies and Institutions*, OECD (2001).
15. *www.departments.bucknell.edu/russian/const/1977toc.html*.
16. *www.departments.bucknell.edu/russian/const/constit.html*.
17. *www.arbitr.spb.ru*.
18. *www.bisnis.doc.gov/bisnis/isa/990702RFfil.htm*.
19. Article 6.
20. "The legal regime governing the investment activities of a foreign investor and use of profits obtained from such investments may not be less favorable than the legal regime governing the investment activities and use of profits obtained from such investments established for Russian investors, with the exceptions established by federal laws" (Article 4, paragraph 1).
21. Article 8.
22. Article 11.
23. Article 13.
24. Article 14.
25. Article 15.
26. The Land Code of the Russian Federation No. 136-FZ, adopted by the State Duma on 28 September 2001, and approved by the Council of Federation on 10 October 2001.
27. Rights to perpetual or indefinite use were originally granted under a Soviet Law of 1921. While most of the grants were to villages and municipalities, some legal entities also held these rights.
28. Federal Law No. 102-FZ, "Concerning Mortgages (Pledges of Immovable Property)", dated July 16, 1998 (as amended), Article 63.
29. Russian Trading System.
30. Except for two provisions on general shareholders meetings that went into effect on 9 August 2001.
31. Article 40, Federal Law No. 208-FZ (December 26, 1995) "Concerning the Introduction of Amendments to the Law on Joint Stock Companies", as amended by Federal Laws No. 120-FZ (August 7, 2001) and No. 134-FZ (October 31, 2002).
32. Article 28, paragraph 2.
33. Article 28, paragraph 6.
34. Article 25, paragraph 2.
35. Article 32, paragraph 4.

36. Article 19, paragraph 3.
37. Articles 52 and 53.
38. Article 44.
39. This changes also involved amendments to the Labour Code.
40. See, *e.g.*, Article 89, paragraph 1 and Article 91.
41. See, *e.g.*, Articles 92 and 93.
42. Federal Law No. 39-FZ, "Concerning the Securities Market" (April 22, 1996) as amended by Federal Law No. 195-FZ (December 28, 2002).
43. Financial consultants must be FSFM-licensed brokers or dealers in the securities markets. According to FSFM, in early 2004 there were ten licensed financial consultants in Russia.
44. Presidential Decree 849 "On Plenipotentiary Representatives of the Russian Federation President in the Federal Districts". The districts and their capitals covered by the decree are as follows: Central Federal District (with Moscow as its capital); North-Western Federal District (St. Petersburg); Southern Federal District (Rostov on Don); Volga Federal District (Nizhniy Novgorod); Urals Federal District (Yekaterinburg); Siberian Federal District (Novosibirsk); and Far Eastern Federal District (Khabarovsk).
45. See the Results of two rounds of *Monitoring of administrative barriers to small business development in Russia* on the CEFIR site *www.cefir.ru*. The latest report was published in November 2003.
46. RF Law No. 4015-1, "*On Organisation of Insurance Activity*" dated 27 November 1992, amended by No. 204-FZ, dated 20 November 1999.
47. Federal Law No. 172-FL "On modification and additions to the Law of the Russian Federation", "On organisation of insurance business in the Russian Federation", dated 10 December 2003.
48. The current share of foreign investment of the equity capital of Russian insurance companies is estimated to be between 3 and 5 per cent.
49. As of 31 March 2003, there were 29 wholly foreign-owned banks holding full operating licenses and a further 9 institutions with majority foreign ownership. Although exact data are not available, most commentators estimate that foreign investment in the banking sector accounts for 4 per cent of total capital.
50. Law of the Russian Federation No. 2395-1 of 21 February 1992 on the Subsoil.
51. Law of the Russian Federation No. 225-FZ of 30 December 1995 on Production Sharing Agreements.
52. Presidential Decree No. 1020 "On consolidating Gazprom Stock in Federal Property", dated August 9, 1999.
53. Presidential Decree No. 529 "On Terms of Trading Gazprom Stock within the Period it is Retained in Federal Property", dated May 28, 1997.
54. Federal Law No. 74-FZ "Regarding the Disposing of Shares of RAO UES and other State-Owned Energy Companies", dated May 7, 1998
55. The Law of the Russian Federation No. 15-FZ of 16 February 1995 on Communications did this in Article 8.
56. Law on Communications of 2003, Article 5, paragraph 1.

57. Law on Communications of 2003, Article 5, paragraph 1.

58. Law on Communications of 2003, Article 69, paragraph 2.

59. Law on Communications, Article 15.

60. Law on Communications of 2003, Article 29, paragraph 2.

61. Law on Communications of 2003, Article 30, paragraph 1.

62. Law on Communications of 2003, Article 23.

63. Law on Communications of 2003, Article 24, paragraph 2.

64. See Radygin, A. (2003), "Beneficial Ownership Information Disclosure", presented at the Russian Corporate Governance Roundtable Workshop on Implementation and Enforcement of Disclosure Rules, Moscow, 2-3 October, 2003.

65. OECD 2004a.

66. There has been some recent movement in this area, as the tax service has only recently become liable for a taxpayer's legal costs in the event that the taxpayer prevails in a court challenge against the service.

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Chapter 3

Investment Incentives and FDI in Selected ASEAN Countries*

ASEAN is perhaps the developing country region that has been the most successful at attracting foreign direct investment and at incorporating foreign firms into national development strategies. There has nevertheless been a secular decline in investments in the region by multinational enterprises which began in some countries even before the Asian financial crisis in 1997. This trend, together with far greater investment going into China, is often cited as a major developmental challenge for ASEAN countries. Based on a review of trends and a careful analysis of FDI into the two regions, this article concludes that China represents more an opportunity than a threat to ASEAN and that, ultimately, China and ASEAN will sink or swim together.

ASEAN countries have responded to the challenge by offering incentive schemes, or expanding the use of schemes already in place. However, and in spite of the risk that incentives competition within ASEAN could degenerate into bidding wars, the evidence presented in this study suggests that while incentives have proliferated, their use has not escalated. More countries are involved, but at the same time some countries have reduced or pared down the more general incentive schemes. New, more targeted programmes focus on "strategic" sectors and seek to achieve "dynamic" gains such as human capital formation, technology transfer, industrial clusters and market access abroad. However, this runs close to "picking the winners" strategies and hence carries the usual risks that follow from discriminating between domestic economic sectors.

* This article was prepared by Stephen Thomsen, an external consultant to the Investment Division, OECD. The views expressed are those of the author. They are not necessarily shared by the OECD or by the Organisation's member countries.

The present study was prepared within the framework of the activities of the planned OECD-Asia Investment Initiative. A recent policy statement by the OECD Investment Committee proposed a checklist to aid host governments in assessing the costs and benefits of incentive policies (Annex 3.A1). It moreover made the following observation:

"The aim of policies for attracting FDI must necessarily be to provide investors with an environment in which they can conduct their business profitably and without incurring unnecessary risk. Experience shows that some of the most important factors considered by investors as they decide on investment location are:

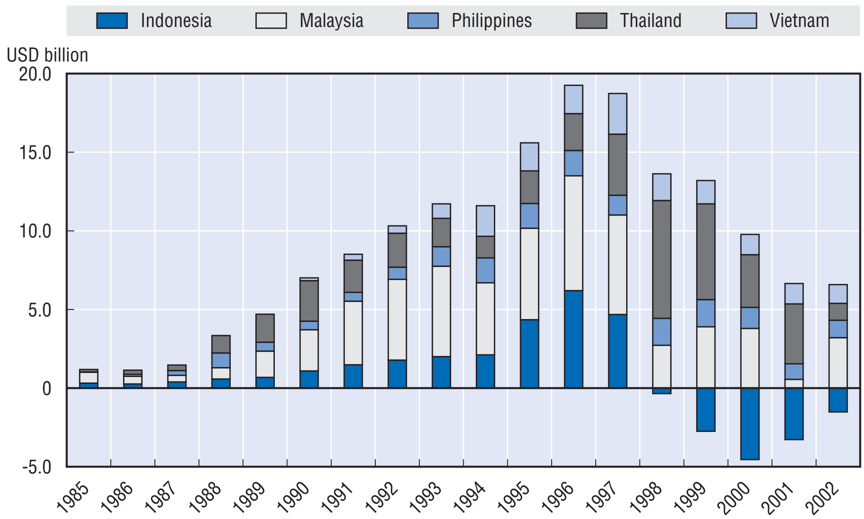
- *a predictable and non-discriminatory regulatory environment and an absence of undue administrative impediments to business more generally;*
- *a stable macroeconomic environment, including access to engaging in international trade;*
- *sufficient and accessible resources, including the presence of relevant infrastructure and human capital."*[1]

The study takes the overarching importance of a strong enabling environment to attract FDI as a starting point. It examines how countries in the ASEAN region have capitalised on the strength of their enabling environment, and how they have attempted to build upon it to maximise the benefits of international investment by means of targeted efforts such as investment promotion, investment incentives and, in some cases, corporate tax policy. Its assessments of incentive policies take place against the background of the Checklist.

1. Foreign direct investment in ASEAN

In the 1990s, ASEAN countries were collectively among the world's largest recipients of FDI, and foreign investors have been a driving force behind the region's export-led development. The fear nevertheless is growing within ASEAN that its best days are behind it as a magnet for FDI. Inflows into the five ASEAN countries covered by this study (Indonesia, Malaysia, the Philippines, Thailand and Vietnam) peaked in 1996, the year before the Asian crisis, but some countries saw their FDI decline even before that. Foreign investment flows into Malaysia have declined in real terms almost every year since 1994. Over the past five years, all five countries have recorded diminishing inflows, and in the case of Indonesia the inward flows have even been negative since 1998[2] (Figure 3.1).

Figure 3.1. **FDI inflows into the ASEAN 5, 1985-2002**



Source: UNCTAD (2003).

Foreign investment in Malaysia began to take off in the late 1980s and early 1990s at a time when Japanese and Chinese Taipei firms were seeking offshore production platforms as a result of rising labour costs and appreciating currencies at home. In Vietnam, interest on the part of investors grew quickly in the five years following the opening up of the economy to foreign investment but has been dropping in almost each year since then as legal uncertainties and poor infrastructure and the ensuing high costs of doing business in Vietnam have discouraged investors.

Investment in Thailand grew rapidly in the year following the crisis, reflecting *inter alia* the fact that many foreign investors bought out their joint venture partners, recapitalised their affiliates and entered new sectors which had been opened up as a result of the crisis. Following this one-off event, inflows to Thailand have declined significantly. Indonesia was an early recipient of FDI, owing to its large market and abundant natural resources but, as already mentioned, has fared poorly in recent years. According to surveys of investors' intentions, foreign firms may have left Indonesia or diminished their presence in response to perceived political instability, corruption and uncertain application of legislation.

Before analysing regional FDI trends in more detail, it is worthwhile to keep in mind a few stylised facts about the ASEAN economies and their investment climates:

- ASEAN member countries are at different levels of economic development and have developed at different paces over recent decades. This affects the composition of FDI inflows, since for example investors motivated by the availability of cheap labour are normally drawn to countries in early stages of development, whereas market-seeking investors and companies in search of specific competences prefer more highly-developed economies. At present, the most highly developed ASEAN economies (measured by GDP per capita) are Singapore and Brunei, followed by Malaysia and Thailand.
- The physical characteristics of the countries in the region differ sharply. By far the largest country in terms of population is Indonesia, which could help attract market-seeking investors (though in terms of overall economic output the difference between Indonesia, Thailand and Malaysia is not so big). At the other end of the scale, Laos is not just sparsely populated but also landlocked. Several countries in the region have raw materials and minerals on their territory, but only Indonesia has them in such quantities that it is likely to have swayed foreign investors (plus Brunei, in the case of the oil industry).
- The economic growth of China during the 1990s, and this country's emergence as one of world's prime locations for FDI, fundamentally changed the economic environment and investment climate in which ASEAN countries operate.

1.1. Where does foreign investment in ASEAN come from?

Since 1995, roughly one third of FDI inflows have come each from Asia, Europe and the rest of the world, principally North America (Table 3.1).[3] The share of each source region has varied across time and among ASEAN countries. Over the period, American and European firms have tended to prefer Malaysia, followed by Thailand; Japanese firms have invested more in Thailand; and the Newly Industrialising Asian Economies outside of ASEAN have opted relatively more for Vietnam.

Some of the variation in investment patterns can be explained partly by the differing profile of investors from each region. Asian investors include a number of comparatively small enterprises seeking low cost offshore production platforms. These firms are often forced offshore by rising labour costs or appreciating currencies in their home countries and, given their limited resources, seek to minimise search costs by choosing locations in neighbouring countries or in those with which they share a cultural affinity.

Table 3.1. **FDI inflows into ASEAN by source country, 1995-2001**

USD million; per cent

	ASEAN		Indonesia	Malaysia	Malaysia[1]	Philippines	Thailand	Vietnam
United States	24 349	17%	–1 368	5 399	8 749	2 818	4 067	459
Canada	2 836	2%	234	–114	–21	3	19	23
EU	36 528	26%	3 351	2 888	6 842	1 726	3 684	1 324
Other Europe	11 713	8%	728	67	325	97	443	493
Japan	22 151	16%	1 069	1 207	3 328	2 291	6 645	1 738
Asian NIEs[2]	11 693	8%	344	342	1 712	912	3 035	4 081
ASEAN	15 257	11%	136	2 422	6 758	1 026	3 903	2 395
Other	17 832	13%	–206	54	2 693	1 242	6 750	1 431
World	**142 359**		**4 288**	**12 265**	**30 386**	**10 115**	**28 546**	**11 944**

1. Including retained earnings.
2. Hong Kong, China; Chinese Taipei; Korea.

Source: ASEAN Statistics Yearbook 2003.

The large Asian multinationals are more likely to resemble investors from Europe and North America. Many of them pursue complex strategies of diversifying value chains across countries while at the same time supplying local markets though own affiliates. Hence they look at an array of factors including market size, openness to foreign trade, the quality of the enabling environment and the availability of domestic competences, all of which favour the more developed economies. These companies are often more interested in the quality of the labour force than in its price. This putative link between investor size and nationality and the changing patterns of investment over time in ASEAN might help to explain the changing origin of investment over time for individual ASEAN countries.

One illustrative example is Malaysia where Japanese and Chinese Taipei firms were the largest investors in the early 1990s as they sought what was then a low wage location for their offshore production. In 1990, these two countries accounted for no less than 60 per cent of approved foreign projects. Their share has since fallen almost every year and since 1998 has averaged only 17 per cent of approvals. Faced with rising labour costs in Malaysia, many of these firms chose to expand more rapidly in other countries. They have since been superseded by European and American firms – investors from the United States and Germany have represented 41 per cent of approvals since 1998 – seeking a relatively skilled workforce and access to the ASEAN market.

In the Philippines, the story is in some ways the obverse. Given its historical links with the United States, the Philippines traditionally received mostly American investment by firms seeking to supply the local market behind high tariff barriers. Since the mid-1990s when the Philippines launched its programme of export processing zones, these zones have attracted the lion's share of investment, two thirds of which has come from Asia.

In the specific case of US based companies, support for the notion that access to local markets is an important factor driving investment is provided by the sales patterns of enterprises' affiliates in ASEAN (Table 3.2). The most populous countries have the greatest share of sales which are local and the lowest share which is exported to the United States. Affiliates in all four markets export between one quarter and one third of their output to non-US destinations, principally to the regional market.

Table 3.2. **Sales patterns of affiliates of US MNEs in ASEAN, 2001**

Per cent of total sales in each host country

Destination of affiliate sales	Indonesia	Malaysia	Philippines	Thailand
United States	3.5	25.6	n.a.	5.6
Host country	73.0	37.6	n.a.	60.2
Third markets	23.5	36.8	23.9	34.2

Source: US Bureau of Economic Analysis.

Not all of the investment in ASEAN countries comes from outside of the region: roughly one tenth of inflows into ASEAN countries originates in other ASEAN members. The share ranges from three per cent in Indonesia, 10-15 per cent in the Philippines and Thailand, to 20 per cent in Malaysia and Vietnam. In almost all cases, this intra-regional activity represents investment by firms operating from Singapore. Only in Vietnam are other ASEAN members active, notably Malaysia and Thailand.

1.2. Into which sectors does foreign investment go?

Recent direct investment into ASEAN countries has not just affected the manufacturing sector (Table 3.3). While one cannot draw strong conclusions on the basis of three years of flows, especially given net outflows from Indonesia, a look at the sectors of greatest investment since 1999 nevertheless highlights the complexity of the issue. Manufacturing is important in the case of each investor country, but often less so than other sectors. Japanese "*sogo shosha*" *trading companies* and European financial firms were major investors in ASEAN during the period. Like many investors they appear to have been driven by local and regional market considerations, including providing services to other foreign investors already in the region.

Within manufacturing, the electronics sector has been by far the most important recipient of foreign investment, which is one reason why this sector now accounts for a third of goods exports from ASEAN. In Philippine "Ecozones", electronic parts and products account for 58 per cent of all

Table 3.3. **FDI inflows into ASEAN by sector and country of origin, 1999-2001**

USD million

	Japan	US	EU	ASEAN	Other Asia
Agriculture, fishery and forestry	–18	–4	96	71	–21
Mining and quarrying	157	707	1 178	732	21
Manufacturing	1 439	3 526	2 484	1 059	792
Construction	–267	–327	3	27	–88
Trade/commerce	2 858	1 081	1 848	181	589
Financial services	–1 862	1 507	5 858	95	915
Real estate	–415	67	–16	–231	32
Other services	489	552	335	928	587
Other sectors	116	214	1 407	366	324
Total	**2 496**	**7 322**	**13 192**	**3 227**	**3 152**

Source: ASEAN Statistical Yearbook 2003.

projects and electrical machinery another 13 per cent. The electronics industry has also been a leading investor in Malaysia, particularly around Penang. Almost 90 per cent of US manufacturing investment in Malaysia is in computers and electronic products, compared to one half in the Philippines and one third in Thailand.

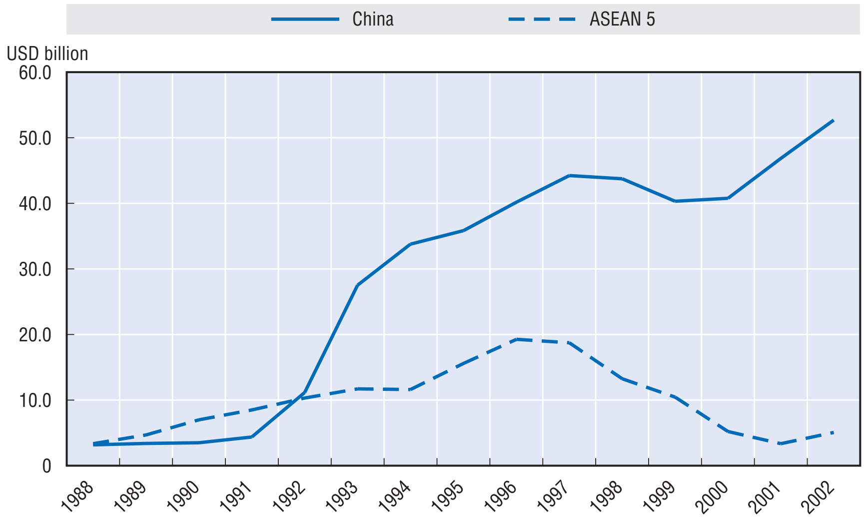
1.3. Is ASEAN losing investment to China?

"There are no doubts that China is a strong competitor for FDI not only for Vietnam but also for all ASEAN-countries", Le Dang Doanh (2002), p. 8.

The fear of losing investment to China has dominated the political discourse of investment-policy makers in ASEAN countries, to the point of overshadowing concerns about potential competition for FDI among these countries themselves. The "Chinese threat" is a frequently cited justification for incentives policies by ASEAN promotion agencies. It is a fear which has been around for a long time and was considered in detail in OECD (1999). Figure 3.2 provides what could be taken to be compelling evidence that while investment flows in the five ASEAN countries are now only a fraction of what they were in the mid-1990s, investors in China seem hardly to stop for breath.

In spite of these diverging trends, it is not obvious that the FDI boom in China has diverted investment that would otherwise have gone to ASEAN, and, even if that were the case, it is not obvious that the ASEAN countries stand to lose from these developments. First and foremost, it is only possible to "compete" for investment if investors are subject to liquidity or other quantitative constraints. Considering the overall amounts of global direct investment flows it would appear that an ASEAN country offering profitable investment prospects will receive FDI, even in the case where certain other countries offer even more

Figure 3.2. **FDI flows to China and ASEAN 5, 1988-2002**



Source: Author on the basis of UNCTAD data.

profitable opportunities. Some countries may have absolute competitive advantages (*e.g.* cheaper labour than their neighbours), but in a world of real exchange rate flexibility they are unlikely to retain them for long.

That said, within sectoral or regional niches the amount of potential investment will of course be limited. This applies, for example, to MNEs' selection of East Asian locations for regional headquarters or export platforms. Countries in the region may aggravate this problem if they focus their efforts at attracting investment on essentially the same sectors. On the specifics of China, the following observations can be made:

- Investment in China is often not a substitute for investment in ASEAN. Almost one half of FDI in China comes from Hong Kong (China) and Chinese Taipei. The investors are in many cases small and medium-sized enterprises that may not have the resources or the inclination to look farther afield. Geographical proximity and cultural affinity lower transaction costs when investing in China. In contrast, over two thirds of investment in ASEAN is from firms from OECD countries with the resources to invest in both ASEAN *and* China. These firms are not selling their assets in ASEAN in order to invest in China (Box 3.1).
- FDI is not a zero sum game, with one country gaining at the expense of all others. Investment in China can stimulate greater FDI throughout East Asia, acting like a regional magnet for investors much as Singapore has done within ASEAN.

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Box 3.1. **Japanese direct investment in ASEAN and China***

Japanese firms have for a long time been among the largest investors in ASEAN and their investments in China have grown quickly in recent years. In 2002 Japanese investment flows into China reached the same level as those into ASEAN for the first time.

Surveys of Japanese investor intentions in the two areas suggest that China and ASEAN will sink or swim together. For instance, a 2001 survey of Japanese firms planning to relocate factories as a result of China's accession to the WTO were asked from where they intended to relocate. Over two thirds planned to shift production from Japan, 16 per cent from the NIEs (excluding Singapore) and only 8 per cent from ASEAN. The largest share of ASEAN production would move from Malaysia. The survey focused only on those Japanese firms planning to relocate some production, which is probably a small minority of total Japanese investors in ASEAN.

Another annual survey asks on a recurrent basis whether Japanese firms plan to expand, maintain or contract their presence in selected countries. While a higher share of firms in China plan to expand than in ASEAN, the share of firms intending to contract in either area is not significantly different, and in both areas, the share planning to contract is declining over time (except for in 1999 which appears to be an outlier).

Survey of Japanese MNEs in Asia

Where do Japanese firms plan to expand, maintain or contract their operations?

	ASEAN 4			China		
	Expand (%)	Maintain (%)	Contract (%)	Expand (%)	Maintain (%)	Contract (%)
2002	44.2	53.0	2.7	70.1	28.7	1.2
2001	51.1	46.2	2.3	76.3	23.2	0.5
2000	46.9	51.3	1.8	59.5	38.9	1.6
1999	26.6	36.2	37.2	35.5	29.0	35.5
1997	66.5	26.2	7.3	68.4	23.6	8.0
1996	74.1	17.1	8.8	75.0	19.7	5.3
1995	79.0	16.2	4.8	85.2	8.2	6.6
1994	81.3	16.9	1.8	93.1	4.0	2.9
1993	69.9	22.1	8.0	91.7	6.4	1.9
1992	57.7	27.9	14.4	81.3	15.6	3.1
1991	67.8	19.8	12.4	71.1	26.3	2.6

Note: ASEAN 4: Indonesia, Malaysia, Philippines, Thailand.
Source: Liu (2003).

As further evidence of the continuing attractiveness of ASEAN, Japanese investors are asked each year which location worldwide has been the best place to invest. In every year since 1993, China has been rated first, but the five ASEAN countries have been in the top ten locations each year since 1994.

* The survey evidence presented here is from various sources and is summarised in Liu (2003).

- Faster growth in China as a result of FDI stimulates ASEAN foreign trade. ASEAN exports to China have grown from 2 per cent of total ASEAN exports in 1993 to 7 per cent in 2001. If one excludes intra-ASEAN trade, China is now the third largest export market for ASEAN.
- Chinese firms are also beginning to invest in ASEAN: almost 1 billion US dollars (USD) since 1995. Although it is a small share of the total, it is growing. Official Chinese figures on approved FDI outflows to ASEAN show 51 projects in Vietnam over the past four years, 23 in Thailand and 9 in Indonesia. The cumulative value of Chinese investment in these three countries amounts to USD 365 million.[4]

1.4. Opportunities and challenges for ASEAN

To say that China is an opportunity for ASEAN countries does not imply that it does not impose challenges at the same time. The rise of China represents part of a long-term process of structural transformation across Asia, of which changing patterns of FDI are only one manifestation. In the mid-1980s, before the Plaza accord and the realignment of currencies, over 80 per cent of investment in Asia by OECD firms was in Singapore, Hong Kong (China) and Chinese Taipei. By 1990, their share had fallen to 50 per cent while the five ASEAN countries' share had risen from 12 per cent to 50 per cent. The appearance of China in the early 1990s meant that by 1995, each group of countries took in roughly one third of OECD investment. As stated in OECD (1999, p. 24):

> Much as the [ASEAN 5] benefited from the declining competitiveness of the [Newly Industrialising Economies, including Singapore], so too has China benefited from similar circumstances in the ASEAN economies. But while the NIEs and Japan moved successfully to higher-value added activities, certain ASEAN countries have encountered difficulties in effecting this transformation. The focus on investment diversion to China should not deflect attention from the domestic causes of this adjustment problem.

Investment incentive programmes in ASEAN are unlikely to be effective unless they assist in the adjustment process. There is some evidence that industrial policies guided by incentives are moving in the right direction. Malaysia is moving away from labour-intensive production, an area where it appears to be losing competitiveness (based on the surveys of Japanese firms mentioned earlier). The Thai Board of Investment has established an office in Shanghai for Chinese investors seeking a location within ASEAN.

2. Investment incentives in ASEAN

Foreign direct investment incentives were defined by the OECD Investment Committee as *measures designed to influence the size, location or industry of a foreign*

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direct investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors.[5] Such incentives directed specifically at foreigners are relatively rare. In most of the cases included in this study, incentives are offered to both foreign and domestic investors, although in practice foreign firms are often best-placed to take advantage of them for a number of reasons. They are often more mobile than local firms, especially when making their first decision about whether to invest in a given location. Foreign firms are also much more likely than domestic companies to fulfil the requirements host country authorities may have defined as a precondition for incentives (*e.g.* export performance or R&D) and are also more often to be found in strategic sectors such as electronics or high technology. Thus, while some incentives are taken equally or even mostly by local firms, some are almost exclusively the preserve of foreign investors even if that is not the expressed intent of the authorities offering the incentive. The focus of the present article is on those incentives which by design or in practice apply mostly to foreign firms.

2.1. Incentives: what and how?

In theory, incentives are intended to act as an inducement to enterprises in situations where the expected societal return to an investment exceeds the risk-adjusted private one. A prime example is the situation where private investment creates spillovers which the investor is unable to internalise and hence does not value appropriately. Spillovers may include the diffusion of knowledge or technologies, human capital formation through the training of workers or enhanced access to foreign markets through the multinational enterprise (MNE).

If the intention of incentives is simply to increase the overall level of investment, particularly but not exclusively by foreign firms, then it could be argued that a uniformly low rate of corporate income tax (CIT) would suffice. But the essence of incentives is selectivity. Not all investments generate the same amount of spillovers and hence it has become the function of a number of incentive programmes to channel investment into certain sectors or areas or influence the behaviour of investors in order better to achieve national development goals. While many firms in many sectors often receive some form of promotion, the most generous incentives are offered to projects fulfilling certain specific development criteria.

Foreign investments are especially promoted because they are perceived to contribute to national development goals, often more effectively than local firms. Some of these goals are listed in Box 3.2. They tend to be part of the incentive system of all countries in this survey, although which particular goals are emphasised depends *inter alia* on the level of economic development and prior success in attracting FDI.

Box 3.2. **Rationales for offering investment incentives**

- *Priority industries:* to promote industrial policies or economic diversification.
- *Exports:* to promote export-led development and enhance access to foreign markets.
- *Employment:* to attract labour-intensive industries.
- *Regional development:* to stimulate economic activity in less developed regions.
- *Training and human capital development.*
- *Innovation and R&D.*
- *Transfer of technology and proprietary knowledge.*
- *Environmental protection:* to encourage greener production techniques, resource conservation and industries involved in waste management or providing pollution abatement equipment.

To achieve these objectives, governments resort to a range of fiscal and non-fiscal (also known as "financial") economic measures, in addition to so-called regulatory incentives (Box 3.3). Financial incentives can amount to outright grants to investors, but in most cases they relate to the free-of-charge provision of infrastructure, training or a range of commercial services by investment promotion agencies. A special kind of incentive – and from a public policy perspective, a particularly controversial one – is the selective relaxation of regulatory obstacles to investment or to the activities of a company once it has located in that country. The distinction between regulatory and other incentives can in practice be somewhat blurred. Duty exemptions on imports which serve as inputs into export production, for example, are likely to be viewed as an essential pre-condition for investing by export-oriented firms given that the producer must compete in international markets. Many developing countries prefer fiscal measures because they do not constitute a direct drain on budgetary resources.

2.2. Investment incentive schemes in ASEAN

National development goals

The countries covered by the present study have all adopted a relatively interventionist approach to development and to the role of foreign firms in that process. In earlier years, and to a certain extent still today, investment promotion coexisted with substantial restrictions on investment by foreign firms. Where foreigners could help fulfil the objectives of either import

Box 3.3. **Investment incentive instruments**

Corporate tax incentives

- Tax holidays or reduced corporate tax rates.
- Tax credits.
- Investment allowances.
- Accelerated depreciation.
- Reinvestment or expansion allowances.
- Double deduction of certain expenses for tax purposes (usually related to *e.g.* employment, exports, R&D or infrastructure).

Other tax incentives

- Personal income tax exemption on dividends.
- Exemption from, or reduction of, withholding taxes.
- Duty drawback schemes.
- Exemption from import tariffs, particularly for capital goods, equipment or raw materials, parts and inputs related to the production process.
- Exemption from export duties.
- Exemption from sales, property and wage income taxes.
- Reductions in social security contributions.

Financial incentives

- Subsidised or concessionary financing.
- Government equity participation.
- Insurance at preferential rates.
- Loan guarantees.
- Direct grants.
- Provision of dedicated infrastructure.
- Provision of training, pre-screening of potential employees.
- Preferential treatment on foreign exchange.
- Preferential government contracts.
- Protection from import competition.
- Subsidised services such as feasibility studies or product marketing.

Regulatory incentives

- Derogations from national and sub-national rules and regulations, *e.g.* social, labour or environmental standards, ethnic quotas, local equity participation.

substitution or export promotion, they were permitted to invest, although their commercial freedom was often heavily circumscribed. With gradual liberalisation, (unilaterally, regionally through ASEAN and multilaterally through WTO) restrictions on FDI have diminished to the extent that most countries maintain only a diminishing negative list of sectors closed to foreign investment and have almost completely phased out the use of performance requirements. As a result, host governments are left with investment incentives as almost the only instrument with which to influence investment behaviour.

Industrial policy has shifted from protecting infant industries (though cases of this still exist) to subsidising investments through incentives in industries which are deemed variously to be "strategic", "pioneering" or "catalytic". At the same time, most host governments also offer special incentives to any investor primarily interested in exporting or, increasingly, in locating in less developed areas. The result is a multi-tiered set of incentive schemes in which firms receive incentives according to sector, activity and location.

Across the world a large number of non-ASEAN countries encourage certain sectors or activities more than others, and many countries and regional groupings also provide incentives to firms to locate in poorer regions. However, ASEAN differs from most OECD countries in the scale and complexity of their incentive schemes. The list of promoted activities and products eligible for "pioneer" status (and hence tax allowances) compiled by the Malaysian Industrial Development Authority (MIDA) runs to 21 pages. The Investment Priorities Plan drawn up the Philippine Board of Investments (BOI) is equally detailed.

Box 3.4 outlines the broad priorities of three ASEAN countries. They take the form of general guidelines appearing on top of more concrete lists of activities eligible for promotion. Priority activities usually receive far greater incentives than those sectors which are promoted as part of a more general national development plan. The overall priorities list does not change much from one country to another; what changes is the particular emphasis given to each priority.

The nature of incentives in ASEAN

The investment incentives of each country are surveyed in Table 3.4. Several observations suggest themselves. First, many ASEAN countries have lowered their CIT rates in recent years, and the standard corporate income tax rates are now all roughly the same for large projects. It is therefore unlikely that an investor would choose one country over another solely on that basis. Second, tax holidays are a popular tool for attracting investment, for up to 10 years in some cases. (The Philippine Department of Trade and Industry reportedly lobbied for holidays up to 12 years in the wake of a failed attempt to lure a large

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Box 3.4. **Priority areas for investment promotion in ASEAN**

Vietnam

Export production; animal husbandry, farming and processing of agricultural produce, forestry and aquaculture; utilisation of high-technology and modern techniques, protection of the environment and investment in R&D; labour-intensive activities, processing of raw materials and efficient use of natural resources; construction of infrastructure facilities and important industrial production establishments; regions with difficult socio-economic conditions.

Philippines

Agriculture and agricultural products; direct involvement in technological and human resource development; public utilities and infrastructure; environmental protection and conservation; targeted industries.

Thailand

Agriculture and agricultural products; industrial zones for environmental preservation, waste water treatment and disposal of refuse, industrial waste or toxic chemicals; international distribution centres; R&D and scientific laboratories; targeted industries, including material for micro-electronics, electronic design and software; software parks.

Source: National governments.

car manufacturer to invest.[6]) Third, the same types of incentives are often made available for similar policy purposes, suggesting that there may be a good deal of imitation of policies adopted in other countries in the region.

Direct comparison of the *scale* of incentives is difficult without adequately detailed information about the *scope* of each incentive in each country. In some countries, pioneer industries include only a few activities, in others, much of the manufacturing sector. Overall, the types of incentives on offer in ASEAN appear to be highly generous in terms of tax holidays, reductions and allowances. Where available, estimates of their costs in terms of foregone fiscal revenue are provided later.

Although a comparison of incentives across ASEAN countries suggests that all five countries offer broadly similar incentives under similar circumstances, there are nevertheless qualitative differences. Of all the countries, Thailand places the greatest emphasis on the location of investment as part of a policy of regional decentralisation in order to relieve congestion in the Bangkok area and to spur growth in outlying regions. Both Thailand and Malaysia are shifting away from a previous emphasis on export promotion towards greater targeting of strategic sectors. In contrast, Vietnam,

Table 3.4. **Investment incentives in the ASEAN 5**

	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Standard corporate income tax rate	(10, 15 and) 30%.	28%.	32%.	30%.	32%.
Tax reduction		"Pioneer" firms pay tax on 30% of statutory income for 5 years. Unabsorbed losses cannot be carried forward to post pioneer period. For strategic projects (*e.g.* high tech industries, R&D activities, strengthening industrial linkages and multimedia industries, full income tax exemption and/or tax relief of 5-10 years can be considered. Investors in poorer regions pay tax on only 15% of their income for 5 years.	For firms in export processing zones, 5% tax on gross income after tax holidays have lapsed. Tax credit of 25% of equivalent duties for substituting domestic for imported raw material or equipment.	50% reduction of CIT for projects located in industrial estates or promoted industrial zones (PIZs) for 5 years after the tax holiday exemption period.	Enterprises with foreign capital pay 25%, but those investments which are encouraged or promoted pay 10, 15 or 20%. In certain industries and regions, 2 year tax holiday from first profitable year and possible 50% tax reduction for two successive years. Investors satisfying a high number of investment promotion criteria shall be exempted from CIT for maximum 4 years starting from first profitable year and possible 50% tax reduction for two successive years.
Tax holiday	3 to 8 years tax holiday for new enterprises in 22 specific sectors.	Full tax holiday for 10 years for strategic projects (*e.g.* heavy capital investment, high levels of technology, or extensive linkages and with a significant impact on the economy), Operational HQ, Regional Distribution Centres and Int'l Procurement Centres. Full tax holiday for 5 years for high-tech, R&D, "strategic knowledge-based" companies and those in the Industrial Linkages Programme or investing in the MSC. 70% exemption for 5 years for some environment-related companies and approved service projects and those providing manufacturing-related services.	Pioneer projects for 6 years and non-pioneer projects for 4 years, with a possible 1 year extension for both under certain conditions. Expansion projects: 3 years (limited to incremental sales revenue/volume). New or expansion projects in less developed regions (except mining and related products): 6 years. Modernisation projects: 3 years. Exporters may receive a tax holiday for exports of new products or to new markets.	Since 12/01, tax holidays are capped at 100% of investment capital. Priority activities enjoy an 8 year exemption and other privileges according to location. Other activities are offered tax holidays by zone: *Zone 1:* 3 year exemption for projects that export 80% of total sales or that are located in industrial estates or PIZs. *Zone 2:* 3 year exemption extendable to 7 years for projects in industrial estates or PIZs. *Zone 3:* same as priority activities.	In certain industries and regions, 2 year tax holiday from first profitable year and possible 50% tax reduction for two successive years. Investors satisfying a high number of investment promotion criteria shall be exempted from CIT for maximum 4 years starting from first profitable year and possible 50% tax reduction for two successive years.

Table 3.4. **Investment incentives in the ASEAN 5** *(cont.)*

	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Loss carry forward	Up to 10 years for priority sectors and in Integrated Econ. Development Areas.		10 years in Special Economic Zones.		Up to 5 years.
Investment tax allowance	In priority sectors or certain areas, reduction of taxable income by up to 30% of investment.	As alternative to pioneer status, a company may apply for an ITA which provides an allowance of 60% or 100% for qualifying capital expenditure incurred within first 5 years (10 years for R&D companies). The ITA can be offset against 70% or 100% of income in each year. Unused allowances can be carried forward until finished. Companies in certain regions will be granted an allowance of 80% of qualified capital expenditure incurred. The allowance can be used to offset against 85% of income in the year of assessment. Also reinvestment allowance (RA) of 60% of qualified capital expenditure for 15 years to be offset against 70% of income in that year, with carry forward.	Tax credits for incremental export revenue.		
Accelerated depreciation, amortisation	Doubling of depreciation in favoured zones/ sectors.	Accelerated depreciation for computer technology and environmental protection industries and, for a 3-year period, for firms for which the RA has expired.	Immediate expensing of major infrastructure investments by exporters in less developed areas (except in mining and forestry).		

Table 3.4. **Investment incentives in the ASEAN 5** *(cont.)*

	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Dividend withholding taxes	15% residents, 10-20% non-residents (50% reduction in favoured sectors or zones).		10-25% on dividends remitted abroad.	10% on dividends remitted abroad; domestic intercompany dividends are partly or wholly exempt.	3, 5 or 7% on dividends remitted abroad (or 5, 7 and 10% depending on the source of the information).
Import duty and VAT exemptions	All approved projects receive full exemption for main machinery and spare parts and 50% for supplementary machinery and a 2-year exemption for raw materials. Duty drawback for goods and materials needed for exports (for companies with an export ratio over 65%), regardless of availability of comparable local products.	For goods to be exported, full exemption is normally granted on components/raw materials, provided local inputs are not available or of sufficient quality. For goods for the local market, full exemption is possible if the component is not produced locally or if there is already no duty on imports of the final product.	Exemptions of duty and VAT on inputs in certain sectors, notably exporters.	For priority activities, full exemption of import duty on machinery, regardless of location: *Zones 1 and 2:* For all investors, 50% exemption on machinery where the duty is over 10%; full exemption on raw and essential materials used in export products for 1 year. *Zone 3:* Exemption of import duty on machinery; exemption on raw or essential materials used in exports for 5 years.	Exemption for machinery and equipment and for specialised means of transport imported as part of the fixed assets of the enterprise.
Other incentives		Numerous incentives exist to promote specific sectors or areas and for *e.g.* R&D or training, SMEs, firms which increase exports.	Deduction of 50% of wages for first 5 years subject to certain conditions. Incentives for Regional Headquarters and Regional Operating HQ. Other deductions in SEZs.	In Zone 3, various deductions for transport, electricity and water costs, as well as for infrastructure and construction costs for 10 years.	Exemption from prevailing export duty.
Main government agencies offering incentives	BKPM.	MIDA, MSC.	BOI, PEZA, SBMA (Subic Bay), CDC (Clarke).	BOI.	

Source: National governments; ASEAN (1998), Fletcher (2002).

the Philippines and Indonesia still actively promote investment in labour-intensive export sectors in order to activate national pools of under- and unemployed labour.

The changing character of incentives

Of the ASEAN countries in this study, Malaysia and, to a lesser extent, Thailand were early movers in terms of investment incentives which may explain why their policies towards investment are generally more nuanced than those in the rest of the area. The case of Malaysia is shown in Box 3.5. A somewhat similar story could be told for Thailand where, since the end of 2001, the BOI has capped tax holidays at 100 per cent of invested capital. The BOI is also in the process of targeting incentives more precisely to areas where Thailand is deemed to have a competitive advantage (see Box 3.3 for a list) and has proposed guidelines for increasing the spillovers from investment in the area of technology and skills.

2.3. Incentive competition among ASEAN countries

A recent study by the OECD Development Centre suggests that "competition for FDI in the ASEAN countries has been a key factor contributing to the growth of investment incentives in the region".[7] Chia and Whalley (1995) argue that the same was true in the 1980s, but they caution that the *perception* of competition for investment is just part of the explanation for the growth in incentives.[8] The sequence of initiatives in the area of investment promotion in the region is shown in Table 3.5. Singapore moved first in this area but was rapidly imitated by other countries offering tax holidays of their own, a fact which may have encouraged it to expand its own incentives a decade later.

While the sequence of events in Table 3.5 confirms a widely held view that competition within ASEAN for investment is driving the proliferation of incentives, it is equally possible that other countries were merely following the apparently successful example of Singapore. Popularly speaking, it could be a case of "follow-the-leader" rather than "tit-for-tat". A specific example may serve to illustrate this point: in 1986, Singapore began to offer incentives for companies interested in establishing a regional headquarters. This was followed immediately – though largely ineffectually – by the Philippines in 1987, and then by Malaysia in 1990 and Thailand soon after.

Chia and Whalley (1995) argue in favour of the leader-follower explanation and consequently suggest that the best way to contain such incentives might be for the leaders (Singapore and, to a lesser extent, Malaysia) to exercise restraint. However, this argument does not necessarily convince. If incentives were offered solely to lure investors that might have

Box 3.5. **Investment incentives in Malaysia: proliferation, not escalation**

Malaysia has arguably the most developed investment promotion strategy among the ASEAN countries in this study, honed over decades to fulfil national development goals. It has generally emulated Singaporean best practices in its approach to promotion. In earlier days this reflected the fact that both countries had relatively small markets with which to entice foreign investors and hence turned more quickly towards export promotion.

If the experience of Malaysia is anything to go by, investment incentives in ASEAN are not so much escalating as proliferating: the overall incentive regime has gradually become somewhat less generous, while at the same time, promotion is being extended to new activities through a growing number of agencies.

Malaysia began to offer incentives at an early stage, primarily in the form of tax holidays to import-substituting firms. Tariff protection was also conferred, but the market was too small to allow viable infant industries to develop. The only lasting attempt to nurture a local industry has been in the automotive sector, with the Proton cars. In the late 1960s, incentives were expanded to include an investment tax credit, which was aimed both at increasing employment and at pioneer industries, including capital-intensive projects. During this period, foreign firms accounted for over one half of a manufacturing sector, which for its part represented only 13 per cent of GDP.

In the 1970s, labour-intensive and export-oriented firms were favoured, including through the creation of export processing zones which exempted firms from most of the restrictions on other investors, including ethnic hiring quotas in favour of the *Bumiputera* majority. In fact, one of the effects of Malaysia's policy of promoting foreign investment has been to provide a counterweight to the economic dominance of the ethnic Chinese minority.

In the early 1980s, the Government embarked on an industrialisation strategy based on local capital. This strategy was, however, curtailed by the recession in the mid-1980s, at which time a Reinvestment Allowance was introduced for foreign and domestic firms.

The country's real push for foreign direct investment began with the Promotion of Investments Act in 1986 which coincided fortuitously with the wave of relocation of Japanese and Chinese Taipei companies mentioned earlier. The late 1980s and early 1990s witnessed a rise in FDI into Malaysia on a scale not seen before, and not since.

Box 3.5. **Investment incentives in Malaysia: proliferation, not escalation** *(cont.)*

It is tempting to postulate a causal link between inflows of FDI and a more active use of investment incentives over this period, but as argued in OECD (1999) Malaysia was also in the right place at the right time. To Japanese and Chinese Taipei firms it offered many advantages over other possible locations in the region: a relatively skilled and productive workforce, which was also English-speaking, good infrastructure, industrial experience, particularly in electronics, and proximity to Singapore which had emerged as the regional hub for MNEs in the electronics sector.

Whatever the reason for its success, the amount of investment Malaysia received during prompted policy makers to become more selective and targeted in their incentive policies. In the early 1990s, both the tax holiday and the investment tax allowance were made less generous for pioneer industries and their approval became more contingent on the fulfilment of certain criteria. After 1995, labour-intensive projects were no longer eligible for promotion unless they were located in certain areas or satisfied other narrow conditions.

This tightening of incentive practices in traditional parts of the economy was accompanied by an expansion in other areas: high-technology, R&D, training, industrial linkages and multimedia (the development of the latter is supported through the establishment of the "Multimedia Super Corridor"). Since 2000, the Government has offered pre-packaged or customised incentives (both fiscal and financial) for investment perceived as "high-quality" and in certain sectors deemed strategic. Incentives have also been tied less to economic performance (*e.g.* exports) and more to corporate citizenship: training, R&D, environmental protection. Incentives in these areas can still be very generous, as seen in Table 3.4.

For more traditional projects, including by domestic firms, some incentives have been retained. The Reinvestment Allowance has been expanded so as to promote industrial deepening by established firms, duty exemptions on imports have been retained, and former restrictions on foreign equity participation and on the employment of expatriates have been substantially relaxed.

Source: OECD (1999), UNCTAD (2002).

invested in other parts of the region, then it might be a viable solution. But ASEAN governments tend to view incentives as a way of managing their own development, and it does not seem likely that they will relinquish this guiding role. Furthermore, as mentioned earlier, in the competition for investment, ASEAN countries fear China as much as they do each other.

Table 3.5. **Incentive legislation in ASEAN countries**

		Act
1967	Singapore	Economic Expansion Incentives Act
	Philippines	Investment Incentives Act
	Indonesia	Investment Law
1968	Malaysia	Investment Incentives Act
1970	Philippines	Export Incentives Act
1971	Malaysia	Free Trade Zone Act
1972	Thailand	Promotion of Industrial Investment Act
1973	Malaysia	(Expansion of incentives to exporters)
	Philippines	(Amendments to earlier Act)
1975	Singapore	(Pioneer industry holiday lengthened)
1977	Thailand	Investment Promotion Act
1979	Singapore	(Investment credits scheme)
	Thailand	Industrial Estate Authority Act
1983	Philippines	Investment Incentive Policy Act
1987	Philippines	Omnibus Investments Code
1990	Malaysia	Free Zones Act
1992	Philippines	Bases Conversion Act
1994	Philippines	Export Development Act
1995	Philippines	Special Economic Zone Act

Source: OECD and national sources.

In spite of the legislative leapfrogging which began in the 1960s, most observers agree that effective competition for investments began only in the 1990s. Not only did Indonesia reinstate its incentives, but the Philippines began actively to court foreign firms. With the American bases of Clarke and Subic Bay reverting to Philippine sovereignty, the country acquired first rate facilities for exporters. At the same time, Vietnam for the first time opened up the economy to foreign investors. By the end of the decade, all ASEAN countries were participating in a contest for mobile investment.[9]

Bidding wars in ASEAN?

In an extensive cross-country survey of investment incentives, Oman (2000) finds that competition to attract investment is widespread and can be intense at both the national and sub-national level. But at the same time, he cautions against drawing the conclusion that "bidding wars" for investment are escalating. Most of the examples of an intensification of competition arise in the case of very large projects in particular sectors such as automobiles and he argues that once global restructuring has run its course in these sectors, there will be fewer of these big-ticket items up for bids.

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This finding is largely corroborated in the case of ASEAN. Anecdotal evidence in this regard is slight, but one case is frequently cited. According to a review of cases in Charlton (2003):

> In 1996, General Motors announced it wanted to build a USD 500 million car plant in Asia. The two locations that fought most fiercely for it were Thailand and the Philippines. Both countries sent in high-level negotiators. Philippines President Fidel Ramos… pitched a generous package of tax breaks and other incentives including an eight-year tax holiday followed by a 5 per cent levy in lieu of all other taxes; Ramos also offered duty-free import of machinery and equipment and government subsidies for training 5 000 workers. At the time, a high-ranking government official was quoted as saying "this is a flagship investment opportunity and we want to get it".

According to the same report, Thailand won the contest by matching the Philippine package and throwing in a 100 per cent refund on raw materials for car exports and a USD 15 million grant towards setting up a GM training institute. But such incentives do not appear as exorbitant relative to what these countries typically offer investors. Except for the specific offer of training, the incentives mentioned above are broadly in line with those in Box 3.3 for a similar category of investor. Felker and Jomo (2000) report that the Ministry of Industry offered to relax local content policies as a bargaining chip, but this too could be construed as a pragmatic *quid pro quo* for an investor concerned about its own ability to compete in export markets.

Hill (1996) offers a substantially different reading of the same case, suggesting that "the Philippines aggressively sought the project, offering many project-specific incentives, while Thailand (apparently) did not bend its rules; Thailand won owing to its superior fundamentals". With no access to deliberations either in the host countries concerned or within GM, any interpretation must remain largely subjective. The fact that Thailand won the "bidding" does not appear to be an aberration: many multinational automobile producers have chosen to locate there since the Thai market for passenger cars is five times as big as the Philippine one.

Another example of a putative bidding war is provided in Charlton (2003) in which an investment by Canon Inc. was lured away from the Philippines to Vietnam by incentives which the Philippines government could not legally match. According to the author, the Philippine Department of Trade and Industry has lobbied for changes to the Omnibus Investment Code to allow a 5 per cent gross corporate income tax and a tax holiday for up to 12 years.

The evidence presented here suggests that, except possibly for certain high-profile projects, the competition for investment is not accelerating. There is keen competition among the countries of the region, but some of this competition concerns the search for the next "big idea", such as high-technology, high value-added services, operational headquarters, financial services, aviation hubs, industrial clusters, etc. Governments are willing to gamble substantial sums to achieve these goals, and it is relevant to ask whether it is money well-spent. But at the same time, countries such as Malaysia and Thailand do not appear to be uncritically chasing foreign investors – let alone at the expense of neglecting the more general enabling environment for investment.

2.4. The costs of incentives in ASEAN

The most pressing potential cost of incentives is the budgetary cost (mostly foregone tax revenue in the case of ASEAN) which can sometimes be substantial. Estimates reviewed below are generally in the range of one half to two per cent of GDP. The discussion which follows focuses on the potential budgetary implications of incentives, but it should nevertheless be kept in mind that incentives can affect the economy in other ways which are even harder to quantify. In particular, incentives introduce the risk of distortions in the host economy. Incentives might be cost effective in terms of encouraging investment, but if they promote a sector in which the host country has no natural comparative advantage, their long-term effect may be to make the host economy worse off.

Estimates of the budgetary costs of incentives require assumptions about what would have happened in the absence of incentives. Would the firm have invested anyway, even without the incentive package? If yes, then the full amount of the tax benefits can be considered as a cost to the host government. If not, then whatever direct and indirect taxes which are levied on that investment could be considered as a net gain to the host country's budget, ignoring any indirect impact the investment might have on the profitability of local taxpaying enterprises.

Calculating foregone tax revenues also requires an estimate of the profitability of the enterprises receiving any benefits. In cases where the investor benefits from a tax reduction, profitability is known by the tax authorities, but investors receiving a tax holiday sometimes have no reporting requirement. The extent of foregone revenue will also depend on the nature of the incentive, but since the level of incentive varies according to the sector of the investor and the location, there may be no representative case on which to base the analysis. The full revenue implications will also depend on the extent to which the host government can claw back some revenue through indirect taxation, such as on personal income or through withholding taxes. Furthermore, the revenue costs will not be constant from one year to the next or over time. In the first years of operation, an investor will have few profits which can benefit from the tax holiday, but the longer the investor has been in

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the country and the longer the tax holiday, the greater will be the potential loss of revenue to the host government.

In spite of this complexity, various estimates exist of the cost of incentives for many of the countries in this survey. The best that can be done is to provide a range within which the true number might lie. The evidence presented below suggests that the budgetary implications of incentives can be significant. At an OECD Conference on FDI relations between the OECD and Dynamic Asian Economies, it was reported that "certain [representatives of Asian governments] let it be known that such subsidies can total the equivalent of up to one, or even two, per cent of GNP, which is very considerable indeed".[10]

In *Vietnam*, the Ministry of Planning and Investment surveys over 4 000 foreign investment enterprises, collecting information on their after-tax profits and the rate of corporate income tax. By grossing up each firm's profit to its pre-tax level and then applying the standard CIT, the revenue loss from corporate income tax reductions to foreign firms is estimated by the International Monetary Fund at USD 76 million in 2001.[11] This estimate is considered significantly to understate the total revenue loss from incentives in Vietnam because only a fraction of firms in the survey actually report their net profits. A further complication arises from the fact that the estimate only applies to a reduction in the CIT and does not include accelerated depreciation or other measures. If instead one compares foreign-firms in Vietnam with state-owned and collective enterprises and with domestic private and mixed enterprises (normalised by the share of each sector to GDP), the possible revenue loss is much greater, estimated at USD 224 million or 0.7 per cent of GDP and five per cent of non-oil revenues.[12]

The budgetary implications of tax incentives in the *Philippines* could be a serious political concern, not least as government revenue as a share of GDP declined from 19 per cent in 1997 to 14 per cent in 2002. Easson (2001) calculates that incentives were costing the Philippine government USD 2.5 billion in foregone revenue and other costs in 1999. In a study which covers the period before the rapid growth in investment inflows, Manasan (1988) estimates the costs of incentives in the Philippines at one per cent of GDP.

In *Thailand*, the net cost of incentives has been estimated at 0.5 per cent of GDP.[13] The Fiscal and Tax policy Division of the Thai Ministry of Finance commissioned a review of incentives in the early 1980s which provides precise estimates of the revenue foregone and generated by incentives in Thailand in 1980 (Table 3.6). The biggest source of foregone revenue was the business tax exemption. The business tax was a cascading tax levied on all inter-firm transactions which was replaced by a value added tax in 1992. Another important source of foregone revenue was the exemption from import duties. With the

Table 3.6. **Estimates of revenue implications of incentives in Thailand, 1980**
USD thousands

Category	Revenue foregone	Revenue generated	Net revenue foregone
Corporate income tax	15 531	8 778	6 753
Import duties			
Machinery	25 547	97	25 449
Raw materials	45 183	783	44 700
Total	70 730	580	70 149
Business tax			
Machinery	10 013	31	9 983
Raw materials	15 912	166	15 746
Total	25 925	197	25 728
Total taxes and duties	**112 186**	**9 555**	**102 631**

Source: Thailand (1984) cited in Halvorsen (1995), p. 429.

decline in tariff rates over time, this source of revenue loss through incentives is also likely to have diminished. In comparison, the foregone revenue from tax holidays and reductions in the CIT is relatively modest. Over one half of the foregone revenue in this area is recouped through other channels.

In *Malaysia*, Doraisami and Rasiah (2001) estimate the potential foregone revenue at 1.7 per cent of GDP in the 1980s, or 10 per cent of manufacturing value added. They suggest that while incentives may have encouraged export-oriented FDI and created employment, some incentives are likely to have been too generous and even redundant.[14]

2.5. The effectiveness of incentives

Do incentives attract more FDI?

Surveys of investment motives among multinational enterprises have a long history. In a review of the literature, UNCTAD (1992, p. 60) concluded that "surveys and other evidence indicate that the sensitivity of total foreign direct investment flows to tax and similar incentives is very low". Similarly, Chia and Whalley (1995) review some studies from the 1980s on incentives in developing countries and conclude that "tax incentives have a small or even insignificant effect on investment".[15]

It is not necessary to review the extensive literature on this topic in the present article, but certain results are particularly relevant for investment incentives in East and Southeast Asia. An early and comprehensive study of investments in developing countries by Reuber *et al.* (1973) found that the importance of incentives varied with the motive for the investment. Export-oriented firms were more likely to view fiscal incentives as an essential part of

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the calculation of whether to undertake the project. But since fiscal incentives include duty exemptions on imports which are of obvious concern to exporters, it is not clear whether tax concessions on the CIT rate were equally essential. Local market oriented firms were rarely swayed by tax concessions, but were more likely to be attracted by import protection. The study concluded that, overall, incentives did not appear to play a vital role in the investment decision.

More recently, Yeung (1996) surveyed investors in ASEAN from Hong Kong (China) and Chinese Taipei. He found that investment incentives *per se* were ineffective in attracting foreign investment. The main reason for investing was to gain a foothold in the market and to follow clients overseas. At an inter-sectoral level, he found that "the role of investment incentives is largely idiosyncratic and important only in specific industries in specific ASEAN countries".[16] These include electronics and food in Indonesia, metal manufacturing in Thailand, and miscellaneous manufacturing in Malaysia, the Philippines and Thailand.

Numerous econometric studies have attempted to distinguish between the overall rate of taxation and incentives *per se*. Root and Ahmed (1978) examined data from 41 developing countries and found that while corporate tax rates were an important determinant, complex incentive schemes and liberal exemptions had no significant impact on investment decisions. Table 3.7 presents the results of econometric studies which have focused specifically on ASEAN countries.

Table 3.7. **Studies on the effectiveness of investment incentives in Asian countries**

	Incentives	
	Not effective	Effective
Indonesia	Tanzi and Shome (1992)	
Malaysia	Tanzi and Shome (1992) Boadway, Chua and Flatters (1995)	
Philippines	Tanzi and Shome (1992) Aldaba (1994) Lamberte (1991)	Manasan (1986) found incentives to have a significant impact on the rate of return and the cost of capital
Thailand	Tanzi and Shome (1992) Halvorsen (1995), FIAS (1999), World Bank (1980)	
Vietnam	Fletcher (2002)	
ASEAN	Manasan (1988)	Aggarwal (1986) for banking and high-technology industries in ASEAN
Cross-country, Asia	Rana (1988) Fletcher (2002)	

Source: Based largely on Chalk (2001), p. 9.

It is still possible that the most recent period is not like the past and that incentives might become important as the ASEAN market becomes more integrated and multinational enterprises seek to rationalise their production accordingly. One recent study provides some evidence that incentives might have become more significant as determinants of worldwide FDI patterns for export-oriented production. Clark (2000) concludes that "empirical work using improved data measuring FDI offers convincing evidence that host country taxation does indeed affect investment flows. Moreover, recent work finds host country taxation to be an increasingly important factor in location decisions".[17] The difficulty in interpreting such studies derives not only from the problems in quantifying incentive levels but also from the need to distinguish among incentives, in particular between tax incentives and those which provide relief from domestic regulations and import duties. This latter category is often cited by investors as a significant factor.

Another way to assess whether incentives affect investment decisions is to measure the rate of return on promoted projects with and without the tax incentive. In the case of Thailand, Halvorsen (1995) finds that even without incentives, the rates of return on promoted projects would have been high enough to ensure that the investment was undertaken. He suggests that incentives in Thailand have merely provided windfall gains to projects that would have been undertaken anyway. FIAS (1999) estimates that, on average, only 19 per cent of all firms accessing the various investment incentives in Thailand were truly attracted by them.[18] This confirms the results of a study on Thailand mentioned earlier which estimated that the aggregate redundancy rate for BOI promotion activities was 70 per cent.[19]

Does eliminating incentives lead to disinvestment?

Even if some policy makers were willing to concede on the basis of the evidence presented above that incentives have little effect on FDI inflows, they would not necessarily be willing to assume that the corollary is also true: that the removal of incentives will not lead to a withdrawal by foreign investors. However, there exists an example of a country which did eliminate its incentive programme for a substantial period of time. In 1984, Indonesia reduced its rate of corporate taxation and eliminated its tax incentives for investors at the same time. According to a review of the impact of these changes:

> Abolition of tax holidays… had, at most, very slight, temporary effects on the growth of foreign and domestic investment. The main effect was to induce a large rescheduling of proposals from later years forward to 1983 to enable firms to take advantage of the double incentive of pre-tax-reform tax holidays and post-tax-reform reduced tax rates. Most of this rescheduling was in the manufacturing sector.[20]

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The holidays were reintroduced in 1996 and then dropped again, only for new incentives to appear in 2000. Tariff exemptions were maintained over the entire period. As the largest investors in Indonesia, Japanese firms complained the loudest about the repeal of the incentive programme, but they continued to invest after 1983. The decision to offer incentives again after 1996 occurred when inflows were at their peak and hence did not derive from any secular decline in inflows over time. Rather, Wells and Allen (2001) attribute the policy reversal to pressure, partly via the investment agency BKPM, from established investors – both domestic and foreign – who were keen to receive a subsidy if one was made available, and to the fact that the government was benchmarking the generosity of its schemes with those of other ASEAN countries.[21]

A second source of support for the notion that eliminating incentives will not discourage investment comes from a survey by the ASEAN Secretariat of 234 MNEs from all the major source countries for FDI in ASEAN. These firms were asked what the impact of a WTO-orchestrated reduction in local and regional incentives would be on future investment in ASEAN. The results in Table 3.8 provide considerable support for the notion that the removal of incentives will not have a great impact on investment decisions. Only in the case of Japan did some firms respond that the removal of incentives would have a large negative impact on investment, but there were just as many Japanese firms claiming it would have a large positive impact. A slightly larger share of respondents mentioned a potential negative impact than a potential negative one, but this result is driven by the responses of firms from Chinese Taipei. As mentioned in Section 1, these firms might well be smaller and hence more easily deterred by a possible adverse change in the fiscal regime.

Table 3.8. **Survey of MNEs in ASEAN concerning the potential removal of incentives**

Impact	Japan	US	Europe	Australia	Chinese Taipei	Total (%)
Large negative effect on future investment	6	0	0	0	0	7 (4)
Small negative effect	13	5	4	3	15	40 (23)
No effect	41	18	8	9	12	88 (51)
Small positive effect	15	7	3	0	3	28 (16)
Large positive effect	6	2	1	0	1	9 (5)

Source: Mirza *et al.* (1996).

3. Summary and conclusions

Investment incentives as a tool of economic policymaking have been growing in popularity. Incentive programmes are expanding partly to replace more traditional tools of industrial policy, such as trade policies, public ownership of industrial enterprises or various impediments to foreign investment such as performance requirements. As these are gradually being negotiated away or unilaterally abandoned, one of the tools left to governments seeking to influence investor decisions is the use of investment incentives.

The growth in incentives poses new challenges for policymakers. Although the "carrot" of incentives is often seen as an improvement over the "stick" of restrictions, the use of incentives nevertheless entails certain risks. Studies tend to find that incentives have at best a marginal influence of investors' decisions. As a result, they are often ineffective, inefficient and expensive for the host country in terms of foregone fiscal revenue. The cost is likely to be even greater when countries engage in bidding wars for multinational investment.

ASEAN is perhaps the developing country region the most successful at attracting foreign direct investment and at incorporating foreign firms into national development strategies. There has nevertheless been a secular decline in investments in the region by multinational enterprises which began in some countries even before the Asian financial crisis in 1997. This trend, together with far greater investment going into China, is often cited as a major developmental challenge for ASEAN countries. Based on a review of trends and a careful analysis of FDI into the two regions, this article concludes that China represents more an opportunity than a threat to ASEAN and that, ultimately, China and ASEAN will sink or swim together.

ASEAN countries are not only important hosts to FDI, they are also among the most active purveyors of incentives for international firms seeking export platforms or access to the ASEAN market. Many of these schemes have been in operation for decades, although they have become considerably more widespread over time. Malaysia and Thailand have been offering incentives for decades, following the successful example of Singapore. Since the 1990s, they have been joined or rejoined by Indonesia, the Philippines and Vietnam.

Assessed against the background of the OECD Checklist for Foreign Direct Investment Incentive Policies (Annex 3.A1) some warning posts can be raised over recent investment incentive practices in ASEAN countries:[22]

- In some countries analysts have identified an apparent divorce between public bodies responsible for the design and the implementation of policies. Relatively few investment promotion agencies management incentives measures have a direct input into the policy-making process.
- Insufficient resources may be devoted to monitoring of incentive schemes, which is part of a broader problem of inadequate programme evaluation. When implementing agencies' resources are stretched thin, in-depth analysis of costs and benefits of policies are among the first activities to suffer.

- In some cases too little attention may have been given to the advantages and disadvantages of individual incentive schemes. Some strategies may be more cost effective than others. Tax breaks are routinely granted, even as experience has shown that they are often not the most efficient way of addressing investors' concerns.
- Governments have been roundly criticised for not being sufficiently transparent – in some cases throughout the entire investment policy process. Some authorities have even kept their priority sectors a secret.
- The recent trend toward an increasing use of discretionary, as opposed to rules-based, policies is at risk of increasing the scope for arbitrariness, opacity and discrimination between enterprises. In more extreme cases this has also created a scope for corruption.
- Too many targets are sometimes being pursued at the same time (*e.g.* an "old" focus on export promotion may coincide with a "new" strategic-sector orientation). Such diverse objectives are not always compatible.

Moreover, incentives for investors in ASEAN have been costly in terms of foregone tax revenue. Estimates from studies reviewed below range from 0.5 to 2 per cent of GDP and it is clear that some countries in ASEAN can ill-afford to be so generous, especially when empirical and survey work suggests strongly that incentives offered by ASEAN countries, like those elsewhere, neither raise significantly investment levels in the economy nor channel effectively that investment into desirable areas. In many cases the money would probably have been better spent on enhancing the national enabling environment for investment.

In spite of the risk that incentives competition within ASEAN could degenerate into bidding wars, the evidence presented in this study suggests that while incentives have proliferated, their use has not escalated. More countries are involved, but at the same time some countries have reduced or pared down the more general incentive schemes. New, more targeted programmes focus on "strategic" sectors and seek to achieve "dynamic" gains such as human capital formation, technology transfer, industrial clusters and market access abroad. However, this runs close to "picking the winners" strategies and hence carries the usual risks that follow from discriminating between domestic economic sectors.

Bidding wars are also curtailed by the budgetary limits on what many ASEAN countries can afford to give away. There is some ambiguous evidence of bidding for certain high-profile projects but little in the way of systematic incentives competition. The article suggests instead that host governments have tended to follow in quick succession the legislative innovations arising elsewhere in the region, often in Singapore. Legislative changes have been follow-the-leader rather than tit-for-tat.

Notes

1. OECD (2003), "Guiding Principles for Policies toward Attracting Foreign Direct Investment", *International Investment Perspectives*, OECD, Paris, pp. 98-100.
2. Gross inflows are defined as the direct investment flows by foreigners in a given location. They become negative when existing inward investors withdraw capital from the foreign-invested companies in the host economy.
3. Some investments from the rest of the world are attributed to countries like the British Virgin Islands which make it difficult to ascertain the ultimate source country.
4. Cited in Michael Vatikiotis, "Outward Bound" Far Eastern Economic Review, 5 February 2004.
5. OECD (2003).
6. *Ibid.*, p. 18.
7. Charlton (2003), p. 17.
8. Chia and Whalley (1995), p. 438.
9. In a recent APEC report, Vietnam vowed to strengthen its efforts to attract foreign companies in the future (APEC, 2003, p. 666).
10. OECD (1993), p. 26.
11. Fletcher (2002), p. 12.
12. Fletcher (2002), p. 13.
13. Chalk (2001), p. 12.
14. Quoted in UNCTAD (2002), p. 207.
15. Chia and Whalley (1995), p. 443.
16. Yeung (1996), p. 514.
17. Clark (2000), p. 1176.
18. Cited in Chalk (2001), p. 9.
19. Thailand (1984), cited in Halvorsen (1995), p. 428.
20. Wells and Allen (2001), p. 55.
21. Wells and Allen (2001), p. 29.
22. Thompsen (2004).

ANNEX 3.A1

The OECD Checklist for Foreign Direct Investment Incentive Policies

In 2003 the OECD Committee on International Investment and Multinational Enterprises agreed on a Checklist for FDI Incentive Policies. The purpose of the Checklist is to serve as a tool to assess the costs and benefits of using incentives to attract FDI, to provide operational criteria for avoiding wasteful effects and to identify the potential pitfalls and risks of excessive reliance on incentives-based strategies. Under six categories, 20 questions are put to policy makers:

The desirability and appropriateness of offering FDI incentives

1. Are FDI incentives an appropriate tool in the situation under consideration?
2. Are the linkages between the enabling environment and incentives sufficiently well understood?

Frameworks for policy design and implementation

3. What are the clear objectives and criteria for offering FDI incentives?
4. At what level of government are these objectives and criteria established, and who is responsible for their implementation?
5. In countries with multiple jurisdictions, how does one prevent local incentives from cancelling each other out?

The appropriateness of strategies and tools

6. Are the linkages between FDI attraction and other policy objectives sufficiently clear?

7. Are effects on local business of offering preferential treatment to foreign-owned enterprises sufficiently well understood?
8. Are FDI incentives offered that do not reflect the degree of selectiveness of the policy goals they are intended to support?
9. Is sufficient attention given to maximising effectiveness and minimising overall long-term costs?

The design and management of programmes

10. Are programmes being put in place in the absence of a realistic assessment of the resources needed to manage and monitor them?
11. Is the time profile of incentives right? Is it suited to the investment in question, but not open to abuse?
12. Does the imposition of spending limits on the implementing bodies provide adequate safeguards against wastefulness?
13. What procedures are in place to deal with large projects that exceed the normal competences of the implementing bodies?
14. What should be the maximum duration of an incentive programme?

Transparency and evaluation

15. Have sound and comprehensive principles of cost-benefit analysis been established?
16. Is const-benefit analysis performed with sufficient regularity?
17. Is additional analysis undertaken to demonstrate the non-quantifiable benefits from investment projects?
18. Is the process of offering FDI incentives open to scrutiny by policymakers, appropriate parliamentary bodies and civil society?

Extra-jurisdictional consequences

19. Have authorities ensured that their incentive measures are consistent with international commitments that their country may have undertaken?
20. Have authorities sufficiently assessed the responses that their incentive policies are likely to trigger in other jurisdictions?

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Chapter 4

Relationships between International Investment Agreements*

International, bilateral and regional investment disciplines have proliferated and new ones are still being negotiated. The present study seeks to increase the level of understanding of the relationships between these disciplines. It singles out the major areas where compatibility issues may arise and reviews the basic rules of international law on their mutual compatibility. The main conclusion is that to judge incompatibility or precedence, the various indicators of the intent of the parties need to be carefully analysed.

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This study cannot be construed as necessarily reflecting the views of the OECD or of this Organisation's member governments or prejudging in any way ongoing or future negotiations or disputes pertaining to these agreements.

International, bilateral and regional agreements have proliferated in the last ten to twenty years and new ones are still being negotiated. It is thus virtually certain that for some more time to come international investment disciplines will continue to co-exist side by side with different terms and sets of parties, and various degrees of overlap. It is therefore important to understand how these agreements would continue to interact and how their overlaps and differences could be managed in a harmonious way.

The present study, with due regard to the complexity of the issues, seeks to increase the level of understanding of the relationships between international investment disciplines, drawing on an analysis of key international investment agreements (IIAs) and OECD's experience with the relationship between its own instruments and other relevant agreements.[1]

The study is organised as follows. Section 1 broadly states the issues being addressed in the paper. Section 2 takes stock of overlaps and differences among a representative sample of investment agreements (namely the bilateral investment treaties, NAFTA, the OECD investment instruments and the WTO agreements). Section 3 singles out the major areas where compatibility issues may arise, and reviews the basic rules of international law on their mutual compatibility. Section 4 suggests some key summing up points. Annex 4.A1 recalls pertinent discussions during the OECD negotiations on Multilateral Agreement on Investment (the MAI). Annex 4.A2 reproduces relevant provisions of the Vienna Convention on the Law of Treaties. Annex 4.A3 presents a synopsis of main elements and overlapping provisions between IIAs.

1. What is at stake?

After the International Trade Organisation (ITO) of the Havana Charter – which contained a comprehensive multilateral set of investment rules – failed to come into being in 1950, host and home countries sought to protect their respective interests by entering into bilateral, regional and multilateral investment-related agreements. Today there are estimated to be more than 2 200 bilateral investment treaties (BITs) and over 175 regional trade agreements (RTAs).[2] The OECD played a prominent role in developing plurilateral "rules of the game" relating to capital movements, dating back to the post-war reconstruction of Western Europe. More recently, in the mid-1990s, the Uruguay Round introduced an "investment" dimension in multilateral trade rules, in that at least some of the new disciplines had implications for foreign investment. Foreign investment-related issues in this sense can be found in at least five WTO Agreements: the GATS, the TRIMs, the TRIPs, the GPA and the ASCM.[3]

This has resulted in an increasingly complex international setting for international investment in which governments have to ensure consistency between differing sets of obligations. The rules of treaty law and specific clauses inserted in individual agreements have traditionally governed the relationship among these various sets of obligations. It is not always clear, however, whether all the legal implications of overlapping obligations are understood in all cases. Each agreement has its own architecture, objectives and cultural and legal specificity. The growing number of investment-related provisions made it increasingly difficult to assess the global picture.

Quite a large number of investment agreements, notably the BITs, while promoting closely related concepts (national treatment [NT], most-favoured nation [MFN] treatment, fair and equitable treatment, full protection and security), contain legal and/or textual variations, sometimes of a subtle nature. This could result in divergent interpretations of the same general obligation under different agreements.

Other questions have been raised regarding the "co-habitation" of various types of investor-to-state and state-to-state dispute settlement procedures or "forum shopping" where an investor may initiate multiple procedures on the same question in order to take advantage of the potentially more favourable dispute settlement provisions available in different agreements. It should be kept in mind that the level of obligations contracted by individual parties to an agreement cannot be disconnected from the coverage of their exceptions/ reservations to the substantive and procedural provisions of the agreement.

2. Distinctive features and areas of overlap

The following section is intended to provide a general indication of the most commonly shared features of existing IIAs and the extent of their mutual compatibility and complementarities.

2.1. Bilateral Investment Treaties (BITs)

As is usually stated in their title, the general purpose of BITs is the "promotion and protection" of investments from one contracting party in the territory of the other contracting party. Most BITs have been concluded between developed capital exporting countries and developing capital importing countries, but a growing number are being negotiated between developing countries. The community of interests is thus becoming broader and more diversified. Influential developing economies such as China, India and Malaysia have concluded a number of BITs, both with developed and developing countries.

While variations exist, two basic model BITs have emerged so far: *a)* the "European model" based on the Abs-Shawcross Draft Convention model endorsed by OECD Ministers in 1962; and *b)* the "North American model" developed in the early 1980s.[4] Both models cover the following major areas:[5] admission and treatment; transfers, key personnel, expropriation and dispute settlement. The main distinction between the two models is that the treatment provisions in the first only apply to an investment after establishment, while the treatment provisions in the second concern also the investment at the pre-establishment phase. Each party of both models can nevertheless make or maintain exceptions, normally using a "top down approach" (according to which all non-conforming measures must be notified), under one of the sectors or matters listed in an annex to the treaty or resulting from laws and regulations applicable at the date the treaty came into force. In addition, the two types of BITs may contain general exemptions to address special situations (such as balance of payments problems, taxation) or concerns (national security or public order). However, the drafting of these commitments varies as the scope of the obligations.

Another major distinction is that the US model disciplines the imposition of a number of performance requirements imposed on investors or their investments and has more elaborated provisions on some matters (such as right of entry and sojourn of aliens) than the European BITs. The two models contain more or less the same concepts for protecting established investments: national treatment and MFN treatment,[6] free transfers of funds, prompt, adequate and effective compensation in the case of expropriation, fair and equitable treatment and full protection and security. They also provide for state-to-state and investor-to-state dispute settlement mechanisms. Investments comprise, in most cases, "all kinds of assets".[7]

The overlaps that occur most frequently between BITs and other international agreements concern the treatment of investors and their investments after establishment, *e.g.* non-discriminatory treatment (MFN and/or national treatment), obligations on the protection of assets, namely guarantees against expropriation and nationalisation without compensation, and dispute settlement procedures for both state-to-state and investor-to-state disputes. As the synopsis table reproduced in Annex 4.A3 shows, there would appear to be potential areas of overlap among several agreements.

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2.2. OECD investment instruments

Taken together, the Code of Liberalisation of Capital Movements and the Declaration on International Investment cover the whole spectrum of investment operations: "right of entry" and "establishment" for non-resident investors and related capital transfers under the Code; and "treatment no less favourable" to established foreign-controlled enterprises "in like situations" with domestic enterprises under the National Treatment Instrument (NTI). They both prescribe the progressive removal of discriminatory treatment against non-resident/foreign-controlled investors. This is a legally binding obligation in the Codes and a "political commitment" in the Declaration. In both cases, parties[8] are allowed to formulate reservations or exceptions (based on a "top down" approach). These reservations/exceptions (and related measures) are subject to "peer reviews", which may result in the formulation of policy recommendations in favour of greater liberalisation. The OECD instruments do not contain legally binding dispute settlement provisions. However, since the Codes contain legal obligations, disputes over them could be brought to other general dispute settlement mechanisms which the parties to the dispute have accepted (*e.g.* the International Court of Justice) or to an *ad hoc* mechanism the parties decide to accept for a particular dispute.

Unlike the Codes, the NTI does not explicitly call for MFN treatment while, as general rule, BITs call for the better of MFN treatment or national treatment. As noted previously, some BITs address also "market access" issues pertaining to establishment. The OECD approach is based on the promotion of "progressive liberalisation" through the mechanisms of transparency, standstill and roll-back of discriminatory measures. The Investment Incentives and Disincentives instrument encourages parties to the Declaration to make investment incentives as transparent as possible so that their scale and purpose can be easily determined. The BITs rarely take up these issues. On the other hand, BITs and some regional agreements (but not the OECD instruments) provide for restitution or compensation for losses incurred due to war or armed conflict, national emergencies or expropriation. They also include binding settlement mechanisms for disputes arising between contracting parties as well investor-to-state investment disputes while the OECD instruments essentially rely on consensus building and consultation procedures.

The OECD Guidelines for Multinational Enterprises set the Declaration apart from other international investment instruments. These are recommendations addressed to multinational enterprises operating in or from adhering governments; they call for responsible business conduct in a variety of areas including employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests, science and technology, competition, and taxation. In June 2000, the Guidelines' implementation procedures were reinforced. A network of national contact points promotes their wide dissemination. The national contact points also act as a forum of discussion for problems that may arise in connection of the interpretation or implementation of the Guidelines.

2.3. The North American Free Trade Agreement (NAFTA)

NAFTA (Chapter 11) is generally considered to be an important recent codification of disciplines and procedures concerning international investment and is increasingly emulated by other agreements.[9] It provides high level standards of protection and liberalisation found in other investment-related agreements and customary international law and offers a dispute settlement mechanism for both state-to-state and investor-to-state disputes. Unlike BITs, which generally use an unqualified illustrative asset list to "define" investment, NAFTA uses a broad enterprise-based, or business activity related, closed list of assets, with specific exclusions. Covered investors generally include, provided that such investors carry on, or seek to carry on, business activities in the Party, all enterprises organised under the laws of another Party irrespective of the nationality of the ultimate owners. Both investors and their investments are entitled to the better of national treatment and MFN treatment and investments are entitled to "treatment in accordance with international law, including fair and equitable treatment and full protection and security" (NAFTA Article 1105),[10] freedom of transfers, and protection against expropriation without compensation. On expropriation compensation, NAFTA contains a more detailed statement of the traditional standard of "prompt, adequate and effective" compensation. Several types of performance requirements are prohibited; some of them (export requirements, technology transfer) are additional to those covered by the TRIMs agreement. These obligations also apply to investments of non-Parties. There are also special provisions prohibiting nationality requirements for senior management but allowing nationality requirements for a majority of the investment's board of directors.

In addition, NAFTA contains both general exceptions and country-specific liberalisation commitments and exceptions to national treatment, MFN treatment and performance requirement rules, senior management and boards of directors and local presence – all listed according to a top-down approach.

In addition to the investment chapter, the NAFTA contains chapters on temporary entry of business persons, financial services, government procurement, competition policy, monopolies and state enterprises, and intellectual property.

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There appears to be both a fair degree of overlap and consistency between the NAFTA provisions on investment and the WTO agreements described below.

2.4. WTO Agreements[11]

Of all the WTO agreements, the General Agreement on Trade in Services (GATS) deals most directly with investment issues. Mode 3 applies to the supply of trade in services through "commercial presence", which is in essence an investment activity. Mode 4 may also regarded as investment-related because it deals, *inter alia*, with the temporary entry of managerial and other key personnel. In accordance with the MFN obligation, parties to the GATS are committed to treating services and service providers from one member in a no less favourable way than like services and service providers from any other as concerns measures affecting trade in services. This is regarded as an "immediate" and "unconditional" obligation.[12] Member specific exemptions from this obligation, permitted at the entry into force of the Agreement, cannot, *in principle*, last more than ten years.[13] National treatment, however, is not automatically accorded across the board. It applies only to scheduled sectors when parties agree to provide national treatment in the context of specific market access commitments, formulated according to a "hybrid" approach involving both "bottom up" and "top down" elements. The GATS provides recourse to the WTO Dispute Settlement Understanding (DSU).

This description (and Annex 4.A3) suggests a rather partial overlap between the BITs and the GATS in connection with service sectors. In the European model BIT, this overlap appears to relate essentially to MFN/NT treatment and state-to-state dispute settlement with respect to assets generated through "commercial presence". In the US model BIT, the overlap may also extend to the establishment of commercial presence. There are also overlaps between the OECD instruments and the GATS.

Building upon existing intellectual property conventions,[14] the Trade Related Aspects of Intellectual Property agreement (TRIPS) provides for national treatment and MFN for the protection of specific categories of intellectual property (copyright, patents, trademarks, etc.). Specific exceptions are provided but no country reservations to this treatment are permitted. In fact, agreement implementation relies a great deal on transparency: member governments are required to publish (or otherwise make available) relevant information pertaining to their intellectual property regime, including "bilateral agreements in the area of intellectual property rights". The agreement is also subject to the DSU. Private rights holders are entitled, in addition, to benefit from certain standards with respect to the domestic enforcement of intellectual property rights and their rights in terms of access to civil judicial procedures. This description (and Annex 4.A3) suggests a significant overlap between the BITs and the TRIPs agreement with respect to the protection of intangible assets and state-to-state dispute settlement. Although this matter does not seem to have been examined in a systematic way,[15] it would appear that both sets of agreements are compatible.

The Trade Related Investment Matters (TRIMs) agreement prohibits certain investment measures relating to trade in goods. These are measures that are inconsistent with the NT obligation of the GATT (which concerns the treatment of imported goods versus domestic goods) or provisions prohibiting quantitative restrictions (Article XI of the GATT). By now, however, all non-conforming measures should have been eliminated. The least-developed countries had until the end of 2002 to do so.[16] A number of extensions or waivers have nevertheless been granted to some countries.[17]

Disputes arising under the TRIMs are handled through the WTO Dispute Settlement Understanding. The main purpose of the TRIMs agreement is to prohibit discrimination between imported and domestic goods (as opposed to *de jure* discrimination between foreign and domestic firms). Performance requirements are usually covered by US BITs under separate provisions. In either case, there would not appear to be any significant issue of incompatibility with the TRIMs Agreement. The typical language used in US BITs, for example, particularly in their latest version, is normally based on TRIMs language.

While the Agreement on Subsidies and Countervailing Measures (ASCM) includes in its definition of subsidies a number of commonly used investment incentives, it does not address this subject in terms of discrimination between foreign and domestic investment.[18] For this reason, and because investment incentives are not an issue usually covered by BITs, even when they include provisions on the making of an investment, there would not appear to be a significant overlap – and thus problems of incompatibility between the ASCM and the BITs.

The "plurilateral" Agreement on Government Procurement deals with the procurement by "entities" specifically covered by the Agreement. It requires both transparency and non-discriminatory treatment in procurement procedures. These requirements not only apply to procurement of foreign products or services but also to goods or services produced by locally established foreign suppliers. The GATS agreement excludes public procurement services and the discussions so far to extend the GATS coverage in this regard has achieved little progress.[19] The OECD National Treatment instrument (NTI), on the other hand, covers discriminatory treatment in regard to government purchasing from established foreign-controlled enterprises. A clarification made by the Committee on International Investment and Multinational Enterprises has established how the relationship between the GPA and the NTI should be understood.[20]

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3. Legal approaches for addressing investment agreement interfaces

The following section examines how international law, as well as different types of investment agreements, deals with the issue of overlap. It is not intended, however, to provide a detailed analysis of the possible implications of overlaps or differences in terms of scope or operation of individual disciplines or specific market access commitments. It also does not address the MFN interface as this issue is the subject of a separate study of this publication.

3.1. General principles of international law

The general rule of interpretation of treaties is given by Article 31 of the Convention on the Law of Treaties (Vienna Convention) (see Annex 4.A2). It provides that a treaty "shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". Thus, a clause of an international agreement must be interpreted according to the ordinary meaning of its wording.

Against this background, the combined reading of Articles 30 and 59 of the Vienna Convention provides the basic rules governing the "application of successive treaties" relating to the same subject matter among some or all of the parties. To simplify the analysis of these provisions, the following two cases are distinguished:

a) The parties to the earlier and the later treaty are the same: In this case the earlier treaty is terminated either if the parties so decide or if the provisions of the two treaties are incompatible (Article 59.1). If not terminated, the earlier treaty is still applied to the extent that its provisions "are compatible with those of the later treaty" (Article 30.3).

b) The parties to the earlier and the later treaty are partially different: In this case, two relationships must be distinguished:

   i) The relations between the parties to both treaties, which are governed by the same rules of case *a)*;

   ii) The relations between a State party to both treaties and a State party to only one of the treaties: in this case "the treaty to which both States are parties governs their mutual rights and obligations" (Article 30.4.b). If the treaties contain incompatible obligations, issues of international responsibility may arise for the State which is party to both treaties toward the State which is party to the treaty the provisions of which are not respected.

In addition, issues of compatibility between treaties can be solved through wording. Article 30.2 states that "when a treaty specifies that it is subject to, or that it is not to be considered as incompatible with, an earlier or later treaty, the provisions of that other treaty prevail".

When the intent is not so expressly stated, there is no automatic result. However, a later treaty with less generous provisions may not necessarily be incompatible with a previous more generous one. The Chairman of the Drafting Committee of the Vienna Convention on the Law of Treaties provided the following example: "if a small number of States concluded a consular convention granting wide privileges and immunities, and those same States later concluded with other States a consular convention having a much larger number of parties but providing for a more restricted regime, the earlier convention would continue to govern relations between the States parties thereto if the circumstances or the intention of the parties justified its maintenance in force".[21]

These are the general rules. How would they apply to the case of IIAs?[22] The issue of successive agreements is likely to become relevant mainly between a later multilateral agreement and previous bilateral agreements, or between multilaterals with overlapping but not fully identical parties. In the case of the OECD's MAI negotiations, most participants seemed to have been seeking to extend prior protections through a multilateral treaty, but not to create a replacement regime that would generally override any more favourable BITs that parties to the MAI might have between them. If a later investment agreement concluded in that spirit contains less detailed provisions or lower standards than those contained in an earlier agreement, the higher level of treatment of the earlier agreement would not be overridden (see Articles 30.2 and 30.3 of the Vienna Convention). There may be cases however, where parties to a later treaty intend to restrict and override an earlier agreement. This may occur, for example, with safeguard provisions, such as a balance of payments provision (BOP) in a multilateral agreement, which can be intended to override an unrestricted transfer clause in an earlier bilateral agreement.[23] In this case, the later treaty would prevail.[24] However, the specific intent of the parties would need to be carefully assessed, in order to ascertain whether they really sought to override in their bilateral (or other multilateral) relationship the previous more generous provisions.

3.2. BITs clauses and other international agreements

BITs often address the matter of compatibility through a specific provision, the "preservation of rights" clause, which simplifies the assessment of intent.[25, 26] That clause seeks to protect the rights of an investor in cases where the provisions of other international agreements[27] are more favourable than the provisions of the BIT. It is usually stated that other laws or agreements providing investment with more favourable treatment shall prevail. This clause may apply to existing as well as to future obligations.

Preservation of rights clauses may differ, however, in the types of laws or agreements to which they apply: they may apply to provisions of international law; provisions of the host country's domestic law; and agreements between the investor and the host country. Provisions applying to the first two categories can be found in BITs concluded by Finland, Germany, Sweden[28] and the United Kingdom.[29] Some provisions apply only to the third category – agreements between the investor and the host country (*e.g.* several BITs concluded by Switzerland). The provisions in the BITs concluded by the Netherlands, the United States and some other agreements apply to all three categories.

The treatment of preservation of rights clauses in the IIAs that were discussed above can be summarised thus:

- *OECD Codes*. The OECD Codes of Liberalisation, in Article 4, on Obligations in Existing Multilateral International Agreements, provide that "nothing in this Code shall be regarded as altering the obligations undertaken by a member as a Signatory of the Articles of Agreement of the International Monetary Fund or other existing multilateral international agreements". Article 4 gives precedence only to multilateral international agreements concluded before the adoption of the Codes, in 1961. This interpretation was confirmed in the early 1990s.[30]
- *NAFTA*. Under NAFTA, a general article (Article 103) provides that in the event of any inconsistency between NAFTA and other agreements to which the NAFTA parties are party. NAFTA shall prevail to the extent of the inconsistency, except as otherwise provided by NAFTA. Article 104 does provide otherwise, however, regarding trade obligations set out in environmental and conservation agreements.
- *The Energy Charter Treaty (ECT)*. The ECT includes a novel provision from a different perspective: that nothing less favourable in other agreements is to be construed as derogating from the ECT. This formulation addresses a concern which BIT drafters have not felt the need to address in their preservation of rights clauses.
- *GATS*. The GATS contains no special preservation of rights provision.

4. Summing up

The present study has drawn the reader's attention to the proliferation and increased sophistication of the investment agreements concluded by governments around the globe during the last decade. It also points to a significant degree of consistency between these agreements, resulting from substantive areas of overlaps. At the same time, the paper underscores the importance of following the interpretation rules of the Vienna Convention on the Law of Treaties to assess the multiple interfaces between these agreements. These observations are supported by the following key points:

4.1. Potential overlaps among main types of IIAs

- Post-establishment MFN treatment and national treatment are, as a general rule, a common denominator of IIAs.
- Pre-establishment and market access provisions, however, are usually found only in "US model" bilateral investment treaties and the investment chapters of some recent bilateral free trade agreements, comprehensive regional agreements (RAs) such as NAFTA, and the GATS.
- The promotion and protection of investments remains mainly the realm of BITs and those RAs which aim at a high level of economic integration (such as NAFTA).
- Virtually all IIAs allow for MFN and national treatment exceptions of various sorts and general exceptions covering national security concerns. Some may contain general exceptions based on public order and balance of payments considerations.
- Dispute settlement mechanisms exist in all cases for state-to-state disputes. Investor-to-state dispute settlement mechanisms are found only in BITs and some RAs.

4.2. International law rules

The Vienna Convention provides that in the case of successive agreements relating to the same subject matter and involving the same parties:

- The later of the two agreements would apply, if the two agreements are incompatible, *i.e.* cannot be applied together.
- However, an earlier agreement with higher standards would not necessarily be considered incompatible with a later one with lower standards, particularly if the intent of the later one is to state the parties' minimum obligations, not preclude other, more favourable, treatment. This is essentially a question of wording and intent.
- There may be cases where the parties intend that a later agreement, which contains more detailed and restrictive provisions, should override the earlier one.
- To judge incompatibility or precedence, the various indicators of the intent of the parties in the agreements would need to be carefully analysed.

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Notes

1. The European Union provisions are not covered by the present study.
2. See "The Relationship between Trade and Foreign Direct Investment, A Survey" [TD/TC/WP(2002)14/FINAL and "The Investment Architecture of the WTO", TD/TC/WP(2002)41/FINAL, both available at *www.oecd.org/ech*], and "Experiences with Bilateral, Regional Approached to Multilateral Co-operation in the Area of Long-Term Cross-Border Investment, particularly Foreign Direct Investment", *UNCTAD/TD/B/COM.2/EM.11/2*.
3. The *General Agreement on Trade in Services* (GATS), the *Agreement on Trade-Related Investment Measures* (TRIMs), the *Agreement on Trade-Related Aspects of Intellectual Property* (TRIPs), the *Agreement on Government Procurement* (GPA) and the *Agreement on Subsidies and Countervailing Measures* (ASCM). These agreements are generally considered to form the "architecture" of the "substantive" investment obligations at the WTO. The WTO *Understanding on Rules and Procedures Governing the Settlement of Disputes* – which applies to all WTO disciplines – can be considered as the procedural facet of this architecture.
4. The expressions "North Americanmodel BIT" or "EU model BIT" essentially refer to the distinctive features originally introduced by Canada or the United States, on the hand, and European countries, on the other, in their bilateral investment treaties agreements. They are not intended to exclude non-Canada/US or non-EU BITs which contain similar features to those found in Canada/US or European agreements. For instance, the investment chapters of Japan's recent free trade agreements with Korea and Singapore cover the pre-establishment phase. Both Canada and the United States have recently undertaken a review of their model BITs (the latest drafts of these agreements are available at *www.dfait-maeci.gc.ca/tna-nac/fipa-en.asp* and *www.state.gov/e/eb/rls/prsl/28923.htm*).
5. The scope of application is also a function of the definition usually given in a separate article to foreign "investment" and/or foreign "investor".
6. It should be noted from the start, that as with other international agreements, including those being reviewed in the present study, both the MFN treatment and national treatment are "relative" standards. This means that they do not set a specific standard but instead establish the standard by reference to existing practice toward other investors. The concept of relativity is further reinforced in some agreements by the additional qualification of "in like circumstances" or "like situations".
7. The United States model uses the following formula whereby a covered investment means every kind of investment, in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt and service and related contracts. The German BIT model (which is one of the oldest European models) defines "investments as comprising every kind of asset, in particular: *a)* movable and immovable property as well as any other rights *in rem*, such as mortgages, liens and pledges; *b)* shares of companies and other kinds of interest in companies; *c)* claims to money which has been used to create an economic value or claims to any performance having an economic value; *d)* intellectual property rights, in particular copyrights, patent, utility-model patents, registered designs, trade-marks, trade-names, trade and business secrets, technical processes, know-how, and good will; and business concessions under public law, including concessions to search for, extract and exploit natural resources. See UNCTAD, Bilateral Investment Treaties in the mid-1990s, 1998, p. 259.
8. The OECD liberalisation Codes are open exclusively to OECD member countries. But in the case of the Declaration, non-member economies willing and able to

meet the requirements of its various components may adhere. Eight non-members, Argentina, Brazil, Chile, Estonia, Israel, Latvia, Lithuania and Slovenia, have already done so. They are entitled to participate in the work related the four constituent elements of the Declaration. On the occasion of their annual meeting in June 2000, OECD Ministers invited the Secretariat to encourage other interested non -members to adhere to the Declaration.

9. A recent survey conducted by the OECD Trade Directorate entitled "The relationship between regional trade agreements and the multilateral trade system: investment" [TD/TC(2002)8/FINAL] cites the examples of the Canada/Chile Free Trade Agreement (1997) and the draft text for the Free Trade Area of the Americas. The revised Convention establishing the European Free Trade Association (2002) and the Agreement between the Republic of Singapore and Japan for a New-Age Economic Partnership (2001) are also reported to have a structure and content broadly similar to that found in the NAFTA investment provisions.

10. On 31 July 2001, the NAFTA Free Trade Commission adopted a binding interpretative statement on Article 1105. Paragraph 2 of this statement provides that the concepts of "fair and equitable treatment" and "full protection and security" do not require treatment in addition to or beyond that what is required by customary international law minimum standard of treatment. Paragraph 3 states that a determination that there has been a breach of another provision of the NAFTA, or a separate international agreement, does not establish that there has been a breach of Article 1105.

11. This section, as well as some other observations made in the Note, draws on the analysis being conducted by the Working Party of the OECD Trade Committee (WPTC) on the investment-related provisions in the WTO agreements. ["A multilateral investment framework and WTO architecture: scoping paper", TD/TC/WP(2002)21, and "The Investment Architecture of the WTO", TD/TC/WP(2002)41/FINAL.]

12. Part II "General Obligations and Disciplines", Article II Most-Favoured-Nation Treatment, paragraph 1 reads: "with respect to any measure covered by this Agreement, each member shall accord immediately and unconditionally to services and service suppliers of any other member treatment no less favourable than that it accords to like services and service suppliers of any other country".

13. Article V of the GATS on Economic Integration does not prevent, however, any of its members from being a party or entering into an agreement liberalising trade in services provided that the conditions of the article are met. Taking into account of paragraph 3 of this article, paragraph 6 provides that an economic integration agreement between developed countries must accord the treatment provided in such agreement to a juridical person constituted under the laws of a party to such agreement and carrying on substantial business in the territory of the parties to such agreement.

14. Such conventions include the 1971 Berne Convention for the Protection of Literary and Artistic Works, the 1967 Paris Convention for the Protection of Industrial Property, the 1961 Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations, 1961, and the 1989 Washington Convention on Intellectual Property in Respect of Integrated Circuits.

15. During preparatory consultations on the paper, the WTO Secretariat indicated to the Secretariat that there was apparently no particular study comparing the protection provided by BITs with regard to intellectual property rights and that found under the TRIPs Agreement.

16. It should be noted, however, that the Doha Ministerial Decision on implementing Issues and Related Concerns urges the Council for Trade in Goods to consider positively requests that may be made by least-developed countries under Article 5.3 of the TRIMs Agreement or Article IX.3 of the WTO Agreement, as well as to take into consideration the particular circumstances of least-developed countries when setting the terms and conditions including time-frames.

17. Extensions have been granted to Argentina, Columbia, Mexico, Malaysia, Pakistan, the Philippines and Romania. Columbia and Thailand also benefit for a waiver. The measures in question were to be lifted by end of 2003 at the latest.

18. Instead subsidies are either prohibited (when they are contingent upon the exportation of goods) or subject to specific disciplines (if they cause "adverse effects on trade").

19. Article XIII(2) of the GATS anticipated that "there shall be multilateral negotiations on government procurement in services within two years from the date of entry into force of the WTO Agreement". This is reinforced by the fact that the initial GATS agreement excluded public procurement services.

20. See National Treatment for Foreign-Controlled Enterprises, OECD, 1993, pp. 33-35.

21. Quoted in I. Sinclair, *The Vienna Convention on the Law of Treaties*, Manchester University Press, 1984, p. 97.

22. This discussion in this paragraph may not apply to many IIAs. Many commentators support the view that in the case of treaties with dispute settlement provisions, including the WTO and NAFTA, dispute settlement bodies may be limited to considering only the obligations in the treaty containing the dispute settlement provisions. The possibility of a dispute settlement adjudicating body considering norms other than those of the treaty itself will depend on the treaty's substantive provisions and its rules concerning the jurisdiction of the dispute settlement body.

23. An illustration of the problems that may arise with respect to the application of the above are the following examples. A and B are both parties to two investment treaties – one multilateral and one bilateral. Both treaties have a "free transfer" provision; one also has a BOP clause, *i.e.* a balance of payments exception to the "free transfer" obligation. If the BOP clause is contained in the first treaty, then customary international law, as reflected in the Article 30 of the Vienna Convention, would support the conclusion that the unfettered free transfer provision of the second treaty would prevail on the basis that the transfer provisions of the two treaties are not compatible. However, if the sequence is reversed and the BOP clause is contained in the second treaty, the unfettered free transfer provision, this time in the first treaty, would appear to be incompatible with the possibility of restricting transfer for BOP reasons, now under the second treaty, and the BOP provision in the second treaty would prevail.

24. However, where the parties to the treaties are not identical, even an explicit intent expressed in the earlier agreement will not limit the rights of those states which are party to only the earlier agreement. See Article 30(4) of the Vienna Convention.

25. The analysis of BITs is based on Rudolf Dolzer and Margaret Stevens, Bilateral Investment Treaties, ICSID, 1995.

26. Some BITs also include an "umbrella" clause seeking to ensure that each party to the treaty will respect specific undertakings towards nationals of the other party. But such undertakings usually refer to contracts between a party and an investor from another party and not to obligations resulting from agreements between governments. One example of such clause is found in the 1933 treaty between the

United Kingdom and St. Lucia provides that: "Each Contracting Party shall observe any obligations it may have entered into with regard to investments of nationals or companies of the other Contracting Party."

27. The following provision is found in US BITs: "This treaty shall from any of the following that entitle covered investments to treatment more favourable than that accorded by this Treaty: *a)* laws and regulations, administrative practices or procedures, or administrative or adjudicatory decisions of a Party; *b)* international legal obligations; or *c)* obligations assumed by a Party, including those contained in an investment authorisation or an investment agreement."

28. For example, the agreement concluded by Sweden with Pakistan (Article 9) provide that it will not "prejudice any rights accruing under national or international law to interests of a national or a company of one Contracting State in the territory of the other Contracting State".

29. Bilateral Investment Treaties in the Mid-1990s, UNCTAD, 1998.

30. This interpretation of Article 4 has been confirmed by the OECD Committee on Capital Movements and Invisible Transactions in 1990 and noted by the OECD Council, in paragraph 27 of the Committee Report to Council C(90)38 on Canada-United States Free Trade Agreement.

ANNEX 4.A1

The Discussions during the MAI Negotiations[1] on Compatibility with other International Investment Agreements

The main issues of compatibility between the MAI and other international agreements were discussed during the MAI negotiations. Since they were negotiating a high standards agreement but with anticipated less than universal participation, the members of the MAI negotiating Group focused on three issues: *a)* the protection of higher level standards of the MAI *vis-à-vis* other agreements; *b)* the extension of the benefits of these norms on a non-reciprocal basis through the MFN obligations of the WTO agreements; and *c)* the protection of the higher level standards existing in other agreements (preservation of rights clause). They addressed "protection" and "liberalisation" issues as well as procedural issues. These issues were left unresolved, however, at the conclusion of the negotiations. The views expressed on them cannot therefore be considered as definitive country positions.

1. MAI and the BITs

A document prepared for those discussions [DAFFE/MAI(96)26][2] stated that: "… The need for a non-derogation clause is questionable. A more generous existing agreement would not be overridden by a less generous MAI provision. A later provision would override an earlier provision to the extent it was incompatible, but incompatibility is essentially a matter of intent. Successive investment instruments share the common objectives of investment liberalisation and protection, and are intended to grant rights to private parties, not curtail them." Hence, it argued that even if the MAI were to contain less detailed provisions or lower standards than those contained in the existing BITs, this, *per se*, would not create any particular difficulty. The treatment provided to investment under a BIT would not be overridden. This document did not address the instances in which the MAI parties might have wished to override earlier more generous provisions, such as unqualified transfer rights, since these would have been excluded from a non-derogation or preservation of rights clause in any event.

2. MAI and the OECD

During the MAI negotiations there were discussions on the relationship between the MAI and the OECD instruments. A range of interests covered by the existing OECD instruments would have been protected under the MAI. The MAI was to provide for non-discrimination in both the establishment and post-establishment phase. National treatment was at the heart of the MAI where it would have been a legal obligation, while it remains substantively non-binding under the OECD National Treatment Instrument. Liberalisation, rollback and other relevant concepts of the OECD instruments were also part of the negotiations.

In the area of overlap, the terms of the MAI were not identical to those of the OECD Codes and Declaration. If conflict were to occur, the MAI would have prevailed under the normal treaty rules.

If with respect to contents, OECD members had considered the Codes and Declaration to become to some degree redundant, it would have been for the relevant OECD Committees and the OECD Council, to consider the implications and make the appropriate adjustment in those instruments.[3]

3. MAI and the WTO

With respect to the overlap between the MAI and the WTO agreements, differences in wording and intent might have required different levels of treatment. Negotiators held the tentative view that this would not have created a conflict, since the higher of the two standards would have been available. In cases in which the agreements would have addressed a different subject matter and not overlapped, *i.e.* the subject of expropriation was addressed by the MAI but by none of the WTO agreements, the agreements would have been complementary.

3.1. MAI and the GATS

The issue was raised that Article II of the GATS could give rise to a free rider problem.[4] This article provides that a GATS member must "accord immediately and unconditionally to services and service suppliers of any other member treatment no less favourable than that it accords to like service suppliers of any other country".

The negotiators examined, for example, the case in which a MAI member might be prepared to subject to MAI disciplines a service sector that it had not listed in the GATS schedule; or the member might have been prepared to offer, in a given service sector, a greater level of national treatment in the MAI negotiations than it offered in the GATS negotiations. It was considered that each country would have to take a policy decision on the acceptability of undertaking a higher level of obligations under the MAI which would then be extended, on an MFN basis to all GATS members.

It was suggested at one point that, to overcome the free-rider concern, the Negotiating Group should explore the option of defining the MAI as an economic integration agreement under Article V of the GATS on "Economic Integration". This article provides that GATS members may enter into an agreement that liberalises trade in services provided that certain requirements are met. Such agreements may be exempted from the application of the MFN treatment. Serious doubts were expressed as to whether it could be possible to obtain this derogation however.

The Negotiating Group also considered whether Article II of the GATS was to apply to procedural obligations as well as substantive ones. In particular, would Article II oblige MAI members to extend the provisions of the MAI on investor-to-state dispute settlement to investors from non-MAI states? While the WTO Secretariat suggested that they would, the view that seemed to prevail among the negotiators was that the GATS definition was focused on substantive measures that affect trade in services and that GATS rights could be subject only to dispute settlement under the WTO procedures.[5]

3.2. MAI, TRIPs and other intellectual property agreements

One of the difficulties of analysing the relationship between the proposed MAI provisions and those in the WTO was that, in some cases, it was not clear whether the standards were, or intended to be, higher. The area of intellectual property rights was an illustration of this. The MAI called for the granting of the full range of investment protection to the intellectual property rights of investors: national and MFN treatment, fair and equitable treatment, full and constant protection and security, protection against expropriation and compensation in the event of expropriation. The TRIPs Agreement would appear to cover the same areas, but with a great deal more specificity.

The MAI negotiating group was in agreement that the MAI should not have the effect of extending national treatment/MFN obligations regarding intellectual property beyond those in existing intellectual property agreements. Before the end of the negotiations, further work had been planned to clarify the relationship of the MAI to other IP agreements.[6] It was noted that both in the NAFTA chapter on Investment and in the European Energy Charter Treaty, provisions addressing these matters were included.[7]

4. Dispute settlement issues – forum shopping and multiple proceedings

Inconsistent or differently worded provisions could lead investors to "forum shopping" or to multiple proceedings. The MAI Negotiating Group had begun to consider the dispute settlement issues arising from the relationship between the MAI and other international agreements, including the WTO agreements.[8] The main objectives were focused on the avoidance of forum shopping, multiple procedures and contradictory awards.

Although forum shopping is not uncommon in legal systems, MAI negotiators expressed the view that it would be desirable to minimise it. Although multiple proceedings for the same legal dispute are improbable and legally incompatible awards, in a narrow sense, unlikely, a defendant party may find itself faced in several fora with very similar but not legally identical complaints. The dispute settlement framework and the draft articles of the MAI reflected some initial judgements on how to address the issues of choice of forum. A provision was to preserve the MAI Party's right to take to state-to-state arbitration a dispute which was subject to an investor-state proceeding. The text proposed to accept the possibility that a MAI Party might win a state-to-state award finding its measure was not a treaty violation, while it might lose on that point in an investor-state panel and be held to pay damages to the investor. MAI negotiators had treated this as acceptable and had insisted that the state-to-state award did not affect the validity of the investor to state award.

In order to limit the parties' discretion and therefore dual proceedings, the Negotiating Group had examined two choices: *a)* to require an investor to make an exclusive choice when essentially the same rights (*e.g.* MFN or national treatment) regarding the same investment were in dispute; or *b)* to require the investor to make that choice when the same economic interest or investment is being litigated, even under different core rights. On this issue, NAFTA presents one possible response: under Article 2005 of the Agreement, a NAFTA party must elect whether to proceed under the NAFTA or in the WTO in any case where the dispute concerns "any matter arising under both agreements". Failure to comply with this obligation would itself constitute a violation of the NAFTA.[9] The Negotiating Group had not taken any decision on whether the MAI might have also contained a provision requiring or encouraging Parties to proceed under the MAI rather than another agreement.

Notes

1. Most documents prepared during the MAI negotiations are available on the OECD web site: *www.oecd.org/daf/mai*.
2. Available on the OECD web site: *www.oecd.org/daf/mai*.

3. However, the MAI was not planned to cover completely the matters dealt with in the OECD instruments. For example, the Codes also cover liberalisation of capital outflow operations, and most current invisible transactions, including "non-border" trade in certain services most of which was not to be covered by the MAI. The Capital Movements Code also covers the full range of capital inflow operations, while the breadth of the investment definition in the MAI was not entirely settled. The Codes were thus expected to retain their value as a basis for promoting liberalisation by OECD members and as a yardstick for gauging the readiness of non-member countries to join the Organisation.

4. "The relationship between the MAI and the WTO Agreements: Note by the Chairman", DAFFE/MAI(96)21.

5. GATS Article II requires MFN treatment "with respect to any measure covered by this Agreement". Article I provides that the GATS apply to "measures by members affecting trade in services". Article XXVIII of the GATS states that: "measures by members affecting trade in services" include measures in respect of:
   1. the purchase, payment or use of a service;
   2. the access to and use of, in connection with the supply of a service, services which are required by those members to be offered to the public generally;
   3. the presence, including commercial presence, of persons of a member for the supply of a service in the territory of another member.

   Article II requires a GATS member to accord MFN treatment with respect to beneficial measures that come with the foregoing definition. The definition would appear to be focused on substantive measures that affect trade in services.

6. With respect to National Treatment (NT), MFN treatment and General Treatment no conclusion was reached as to:
   – whether there should be a NT/MFN exception through a link to existing IP agreements;
   – whether there should be a NT/MFN exception to MAI obligations for IPRs;
   – whether the eventual solution should also be applied to the General Treatment articles; and
   – the applicability of the MAI obligations with respect to future IPRs.

7. Article 10, paragraph 10, of the Energy Charter Treaty provides:
   "Notwithstanding any other provision of this Article, the treatment described in paragraphs (3) and (7) shall not apply to the protection of Intellectual Property; instead, the treatment shall be as specified in the corresponding provisions of the applicable international agreements for the protection of Intellectual Property rights to which the respective Contracting Parties are parties."

8. "Dispute Settlement issues arising from the relationship between the MAI and other International Agreements, including the WTO agreements DAFFE/MAI/EG1(96)14."

9. The NAFTA leaves it to the Parties and, if necessary, to a dispute settlement panel, to determine what constitutes a matter arising under both the NAFTA and the WTO agreements.

ANNEX 4.A2

Vienna Convention on the Law of Treaties[1]

Article 30. Application of successive treaties relating to the same subject matter

1. Subject to Article 103 of the Charter of the United Nations, the rights and obligations of States parties to successive treaties relating to the same subject- matter shall be determined in accordance with the following paragraphs.
2. When a treaty specifies that it is subject to, or that it is not to be considered as incompatible with, an earlier or later treaty, the provisions of that other treaty prevail.
3. When all the parties to the earlier treaty are parties also to the later treaty but the earlier treaty is not terminated or suspended in operation under Article 59, the earlier treaty applies only to the extent that is provisions are compatible with those of the later treaty.
4. When the parties to the later treaty do not include all the parties to the earlier one:
   - as between States parties to both treaties the same rule applies as in paragraph 3;
   - as between a State party to both treaties and a State party to only one of the treaties, the treaty to which both Sates are parties governs their mutual rights and obligations.
5. Paragraph 4 is without prejudice to Article 41,[2] or to any question of the termination or suspension of the operation of a treaty under Article 60[3] or to any question of responsibility which may arise for a State from the conclusion or application of a treaty the provisions of which are incompatible with its obligations towards another State under another treaty.

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Article 31. General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
   - any agreement relating to the treaty which was made by one or more parties in connexion with the conclusion of the treaty;
   - any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
   - any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
   - any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
   - any relevant rules of international law applicable in the relations between the parties;
4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32. Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to determine the meaning when the interpretation according to Article 31, or to determine the meaning when the interpretation according to Article 31:

a) leaves the meaning ambiguous or obscure; or

b) leads to a result which is manifestly absurd or unreasonable.

Article 59. Termination or suspension of the operation of a treaty implied by conclusion of a later treaty

1. A treaty shall be considered as terminated if all the parties to it conclude a later treaty relating to the same subject matter and:

   i) it appears from the later treaty or is otherwise established that the parties intended that the matter should be governed by that treaty; or *ii)* the provisions of the later treaty are so far incompatible with those of the earlier one that the two treaties are not capable of being applied at the same time.

2. The earlier treaty shall be considered as only suspended in operation if it appears from the later treaty or is otherwise established that such was the intention of the parties.

Notes

1. Concluded in Vienna on 23 May 23, 1969. Came into force on January 27, 1990. Ratified by 70 countries.
2. Article 41: Agreements to Modify Multilateral Treaties between certain of the Parties Only.
3. Article 60: Termination or Suspension of the Operation of a Treaty as a Consequence of its Breach.

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ANNEX 4.A3

*Main Elements/Overlapping Provisions between International Investment Agreements**

* This table has been constructed drawing on Table V.3. included in UNCTAD's 1996 World Investment Report: Investment, Trade and International Policy Arrangements.

Element	Bilateral agreements		Inter-regional agreements		Regional/economic integration agreements		Multilateral agreements				
	US model	European model	OECD CCM[1]	OECD declaration[2]	Energy charter treaty	NAFTA	GATS[3]	TRIMS[4]	TRIPS[5]	GPA[6]	ASCM[7]
Legally binding	x	x	x	Only decisions	x	x	x	x	x	x	X
Definition of FDI											
a) Investment	Every kind of investment	Every kind of asset	All capital movement operations which give the possibility of exercising an effective influence on the manageme nt (OECD FDI benchmark definition)		Every kind of asset owned or controlled directly or indirectly by an investor[8]	Every kind of asset except debt securities of or loans to a State enterprise	Any service in any sector except services supplied in the exercise of government al authority		All categories of intellectual property referred in the Agreement		
b) Investor	A national or company	A national or company	A non-resident	Foreign-controlled enterprises	A national or company	A national or a company	Service supplier (a national or a company)		Natural or legal persons		
Entry and establishment	x		x	x	x	x	x				
Standards of treatment											
a) National treatment	x	Most, not all		x	x	x	x (scheduled)		x		
b) Most favoured nation treatment (MFN)	x	x	x	x	x	x	x	x	x		
Exceptions to MFN:											
– Econ. integration	x (not all)	x	x[9]				x				

Element	Bilateral agreements		Inter-regional agreements		Regional/economic integration agreements		Multilateral agreements				
	US model	European model	OECD CCM[1]	OECD declaration[2]	Energy charter treaty	NAFTA	GATS[3]	TRIMS[4]	TRIPS[5]	GPA[6]	ASCM[7]
– Reciprocity		x	x (Annex E)	x							
– International agreements	x	x	x			x		x			
– Country exceptions	x	x	x		x	x					
– Exemptions to MFN			X				x				
c) Fair and equitable treatment	x	x	x	x	x	x			x		
Transfer of funds	x	x	x		x	x					
Protection standards											
a) Minimum international standard of protection	X	x		x	x	x					
b) Expropriation	x	x			x	x					
c) Recourse to international means for settlement of investment disputes	x	x			x	x	x				
Transparency	Some		x	x	x	x	x	x	x		
Incentives				x	x		x	x			

1. OECD Code of Liberalisation of Capital Movements.
2. OECD Declaration on International Investment and Multinational Enterprises.
3. General Agreement on Trade in Services (GATS).
4. Agreement on Trade-Related Investment Measures (TRIMs).
5. Agreement on Trade-Related Aspects of Intellectual Property (TRIPs).
6. Agreement on Government Procurement (GPA).
7. Agreement on Subsidies and Countervailing Duties (ASCM).
8. It includes any rights conferred by law or contract or by virtue of any licenses and permits granted pursuant law to undertake any Economic Activity in the Energy Sector.
9. Members part of a special customs or monetary system – not necessarily regional.

Source: OECD.

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Chapter 5

Most-Favoured-Nation Treatment in International Investment Law*

Most-Favoured-Nation (MFN) treatment is one of the oldest standards of international economic relations. It is central to WTO disciplines and is as well a significant instrument of economic liberalisation in the investment field by spreading more favourable treatment from one investment agreement to another. The wording of MFN clauses varies, however, and their interpretation and application requires a careful analysis, on a case-by-case basis, in accordance with Articles 31 and 32 of the Vienna Convention. The ejusdem generis *principle provides that an MFN clause can attract the more favourable treatment available in other treaties only in regard to the "same subject matter", the "same category of matter", or the "same class of matter". Past arbitral findings show, however, that the application of this principle has not always been simple or consistent. The present study reviews the jurisprudence and recommends to negotiators to pay particular attention to the formulation of the MFN clauses in investment agreements.*

* This study was prepared by Marie-France Houde, Investment Division, OECD, and Fabrizio Pagani, Legal Directorate.

This study cannot be construed as necessarily reflecting the views of the OECD or of this Organisation's member governments or prejudging in any way ongoing or future negotiations or disputes pertaining to these agreements.

1. Introduction

Bilateral and regional investment agreements have proliferated in the last decade and new ones are still being negotiated. Most-Favoured-Nation (MFN) clauses link investment agreements by ensuring that the parties to one treaty provide treatment no less favourable than the treatment they provide under other treaties in areas covered by the clause. MFN clauses have thus become a significant instrument of economic liberalisation in the investment area. Moreover, by giving the investors of all the parties benefiting from a country's MFN clause the right, in similar circumstances, to treatment no less favourable than a country's closest or most influential partners can negotiate on the matters the clause covers, MFN avoids economic distortions that would occur through more selective country-by-country liberalisation. Such a treatment may result from the implementation of treaties, legislative or administrative acts of the country and also by mere practice.

The present article provides a factual survey of jurisprudence and related literature on MFN treaty clauses in investment agreements with a view to contributing a better understanding of the MFN interfaces between such agreements.

- *Section II* defines the MFN clause, traces back its origins and provides some examples of such provisions in the two major types of model investment agreements in existence (the "North American model" and the "European model").
- *Section III* summarises the relevant aspects of the extensive work carried out by the International Law Commission (ILC) between 1968 and 1978 on MFN clauses.
- *Section IV* describes recent arbitral awards on the scope of application of MFN treatment clauses resulting from disputes under investment treaties.
- *Section V* provides a summing up.

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2. Definition, origins and examples of MFN clauses

2.1. Definition

To provide MFN treatment under investment agreements is generally understood to mean that an investor from a party to an agreement, or its investment, would be treated by the other party "no less favourably" with respect to a given subject-matter than an investor from any third country, or its investment.[1] MFN treatment clauses are found in most international investment agreements. Although the text of the MFN clause, its context and the object and purpose of the treaty containing it need to be considered whenever that clause is being interpreted, it is the "multilateralisation" instrument *par excellence* of the benefits accorded to foreign investors and their investments.

While MFN is a standard of treatment which has been linked by some to the principle of the equality of States,[2] the prevailing view is that a MFN obligation exists only when a treaty clause creates it.[3] In the absence of a treaty obligation (or for that matter, an MFN obligation under national law), nations retain the possibility of discriminating between foreign nations in their economic affairs.

2.2. Origins[4]

MFN treatment has been a central pillar of trade policy for centuries. It can be traced back to the twelfth century, although the phrase seems to have first appeared in the seventeenth century. MFN treaty clauses spread with the growth of commerce in the fifteenth and sixteenth centuries. The United States included an MFN clause in its first treaty, a 1778 treaty with France.[5] In the 1800s and 1900s the MFN clause was included frequently in various treaties, particularly in the Friendship, Commerce, and Navigation treaties. MFN treatment was made one of the core obligations of commercial policy under the Havana Charter where members were to undertake the obligation "to give due regard to the desirability of avoiding discrimination as between foreign investors".[6] The inclusion of MFN clauses became a general practice in the numerous bilateral, regional and multilateral investment-related agreements which were concluded after the Charter failed to come into force in 1950.

Its importance for international economic relations is underscored by the fact that the MFN treatment provisions of the GATT (Article I *General Most-Favoured-Nation Treatment*) and the GATS[7] (Article II *Most-Favoured-Nation Treatment*) provide that this obligation shall be accorded "immediately and unconditionally" (although in the case of the GATS, a member may maintain a measure inconsistent with this obligation provided that such measure is listed in, and meets the conditions of, the Annex 1 on Article II Exemptions).

2.3. Examples of MFN Clauses in Investment Agreements

A stock taking of MFN clauses in investment treaties will not yield a uniform picture. In fact the universe of MFN clauses in investment treaties is quite diverse. Some MFN clauses are narrow, others are more general. Moreover, the context of the clauses varies, as does the object and the purpose of the treaties which contain them. Following is a representative sample of these clauses.

Germany has concluded the largest number of BITs. Article 3(1) and (2) of the **German 1998 Model Treaty** combines the MFN obligation with the national treatment obligation by providing that:

> "*(1) Neither Contracting State shall subject investments in its territory owned or controlled by investors of the other Contracting State to treatment less favourable than it accords to investments of its own investors or to investments of investors of any third State.*
>
> *(2) Neither Contracting State shall subject investors of the other Contracting State, as regards their activity in connection with investments in its territory, to treatment less favourable than it accords to its own investors or to investors of any third State.*"

This general MFN provision is not restricted in its scope to any particular part of the treaty containing it. It may also be noted that the 1998 German model BIT contains another MFN provision which only relates to full protection and security and to expropriation which are the matters dealt with by Article 4. Article 4(4) specifically provides that:

> "*Investors of either Contracting State shall enjoy most-favoured-nation treatment in the territory of the other Contracting State in respect of the matters provided for in this article.*"

The same approach is followed by the **Netherlands Model BIT** which in addition combines in its Article 3 the MFN obligation with other standards of treatment, *i.e.* national treatment (whichever of these two treatments is more favourable), fair and equitable treatment and full protection and security. The non-discriminatory treatment is formulated in Articles 3(1) and 3(2) as follows:

> "*(1) Each Contracting Party shall ensure fair and equitable treatment of the investments of nationals of the other Contracting Party and shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those nationals. Each Contracting Party shall accord to such investments full physical security and protection.*
>
> *(2) More particularly, each Contracting Party shall accord to such investments treatment which in any case shall not be less favourable than that accorded either to investments of its own nationals or to investments of nationals of any third State, whichever is more favourable to the national concerned.*"

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Article 3 of the 1996 **Albania/United Kingdom BIT** provides that:

"National Treatment and Most-Favoured-Nation Provisions:

(1) Neither Contracting Party shall in its territory subject investments or returns of nationals or companies of the other Contracting Party to treatment less favourable than that which it accords to investments or returns of its own nationals or companies or to investments or returns of nationals or companies of any third State.

(2) Neither Contracting Party shall in its territory subject nationals or companies of the other Contracting Party, as regards the management, maintenance, use, enjoyment or disposal of their investments, to treatment less favourable than that which it accords to its own nationals or companies or to nationals or companies of any third State.

(3) For the avoidance of doubt it is confirmed that the treatment provided for in paragraphs (1) and (2) above shall apply to the provisions of Articles 1 to 11 of this Agreement."

Articles 1 to 11 cover all the provisions of the Agreement, except the final clauses.

The typical formulation of an MFN clause in the **US and Canadian BITs** covers both the establishment and post establishment phases. It also lists the various operations covered[8] and is explicit in stating that the right only applies "in like circumstances", unlike other BITs (particularly the "European model BIT") which make no reference to the comparative context against which treatment is to be assessed. Recent examples are to be found in the investment chapter of US-Chile Free Trade Agreement[9] and the US-Singapore Free Trade Agreement[10] concluded in 2003, and the 1997 Canada-Chile Free Trade Agreement, which are based on NAFTA language. In the **US-Chile FTA**, Article 10.3: Most Favoured Nation Treatment reads:

"(1) Each Party shall accord to investors of the other Party treatment no less favourable than that it accords, in like circumstances, to investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investment in its territory.

(2) Each Party shall accord to covered investments treatment no less favourable than that it accords, in like circumstances, to investments in its territory of investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of investments."

In the **US-Singapore FTA**, National Treatment and MFN treatment are part of a same article:

"Article 15.4: National Treatment and Most-Favoured Nation Treatment:

(3) Each Party shall accord to investors of the other Party treatment no less favourable than it accords, in like circumstances, to investors of any non-Party with

respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of investments in its territory. Each Party shall accord to covered investments treatment no less favourable than that it accords, in like circumstances, to investments in its territory of investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments. The treatment each Party shall accord under this paragraph is 'most-favoured-nation treatment'.

(4) Each Party shall accord to investors of the other Party and to their covered investments the better of national treatment or most-favoured-nation treatment."

In the **Canada-Chile FTA**, Article G-03: Most Favoured Nation Treatment reads:

"(1) Each Party shall accord to investors of the other Party treatment no less favourable than that it accords, in like circumstances, to investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

(2) Each Party shall accord to investments of investors of the other Party treatment no less favourable than that it accords, in like circumstances, to investments of investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments."

The texts of these agreements are alike in that they make clear that the intent to use the likeness of the circumstances in which the treatment is granted as the basis for comparison. Jurisprudence from MFN clauses with a different basis for comparison, and which focuses on categorizing industries affected by treatment, or categorizing the types of treaties that require the treatment, may be of little relevance to the analysis required by these agreements.

2.4. Restrictions and Exceptions

Many MFN clauses in investment treaties contain specific restrictions and exceptions, which exclude certain areas from their application. Such areas may include *inter alia* regional economic integration, matters of taxation, subsidies or government procurement and country exceptions. Depending on the way these exceptions are drafted, the fact that these limitations are specifically mentioned could be a factor in deciding whether certain other matters are within the scope of an MFN clause. Consider the following examples.

The **1998 German Model BIT** provides in its Article 3, points (3) and (4) that:

"(3) Such treatment shall not relate to privileges which either Contracting State accords to investors of third States on account of its membership of, or association with, a customs or economic union, a common market or a free trade area.

(4) The treatment granted under this article shall not relate to advantages which either Contracting State accords to investors of third States by virtue of a double taxation agreement or other agreements regarding matters of taxation."

The **Dutch Model BIT** contains the following exception to the MFN obligation in the general treatment article (Article 3):

"*(3) If a Contracting Party has accorded special advantages to nationals of any third State by virtue of agreements establishing customs unions, economic unions, monetary unions or similar institutions, or on the basis of interim agreements leading to such unions or institutions, that Contracting Party shall not be obliged to accord such advantages to nationals of the other Contracting Party.*"

In addition, Article 4 of the Model, which only deals with the treatment of taxes, includes in its second part, some exceptions to the MFN treatment and National treatment obligations provided by the first part of that article. This article applies to nationals of Contracting Parties or nationals of any third State which are "in the same circumstances". The whole Article 4 reads as follows:

"With respect to taxes, fees, charges and to fiscal deductions and exemptions, each Contracting Party shall accord to nationals of the other Contracting Party who are engaged in any economic activity in its territory, treatment not less favourable than that accorded to its own nationals or to those of any third State who are in the same circumstances, whichever is more favourable to the nationals concerned. For this purpose, however, any special fiscal advantages accorded by that Party, shall not be taken into account:

a) under an agreement for the avoidance of double taxation; or

b) by virtue of its participation in a customs union, economic union or similar institution; or

c) on the basis of reciprocity with a third State."

The MFN limitations in the **Agreement between EFTA States and Singapore** state:

"Article 40:

2. If a Party accords more favourable treatment to investors of any other State or their investments by virtue of free trade agreement, customs unions or similar agreement that also provides for substantial liberalization of investments, it shall not be obliged to accord such treatment to investors of another Party or their investments. However, upon request from another Party, it shall accord adequate opportunity to negotiate the benefits granted therein…

Article 41: Taxation

1. Except as otherwise provided for in this article, nothing in this Chapter shall create rights or impose obligations with respect to taxation measures.

2. Article 40 shall apply to taxation measures subject to deviations from national treatment that is necessary for the equitable or effective imposition or collection of direct taxes.

3. If a Party accords special advantages to investors and their investments of any other State by virtue of an agreement for the avoidance of double taxation, it shall not be obliged to accord such advantages to investors of another Party and their investments."

The agreements concluded by Canada and the United States since the early 1990s have followed the practice of listing "country" exceptions or reservations to MFN treatment (and other standards) as "non-conforming measures" in separate annexes to the Agreement. For example, Article 15.12 (Non-Conforming Measures) of the **United States** – **Singapore Free Trade Agreement** reads as follows:

1. *Articles 15.4 (National Treatment and Most-Favoured-Nation Treatment)…do not apply to:*
   - *a) any existing non-conforming measure that is maintained by a Party at:*
     - *i) the central level of government, as set out by that Party in its Scheduled to Annex 8A;*
     - *ii) a regional level of government, as set out by that Party in its Schedule to Annex 8A; or*
     - *iii) a local level of government;*
   - *b) the continuation or prompt renewal of any non-conforming measure referred to in sub-paragraph (a); or*
   - *c) an amendment to any non-conforming measure referred to in sub-paragraph (a) to the extent that the amendment does not decrease the conformity of the measure, as it existed immediately before the amendment, with Article 15.4, 15.8, and 15.9.*
2. *Articles 15.4, … do not apply to any measure that a Party adopts or maintains with respect to sectors, sub-sectors, or activities, as set out in its Schedule to Annex 8B.*
3. *Neither Party may, under any measure adopted after the date of entry into force of this Agreement and covered by its Schedule to Annex 8B, require an investor of the other Party, by reason of its nationality, to sell or otherwise dispose of an investment existing at the time the measure becomes effective.*
4. *Article 15.4 does not apply to any measures that is an exception to, or a derogation from, the obligations under Article 16.1.3 (General provisions) as specifically provided in that article.*
5. *Articles 15.4 and 15.9 do not apply to:*
   - *a) government procurement; or*
   - *b) subsidies or grants provided by a Party, including government-supported loans, guarantees, and insurance.*

In addition to the measures listed in Annexes I-II, Annex IV of NAFTA is specifically devoted to exceptions to Most-Favoured-Nation Treatment for treatment accorded pursuant to all prior bilateral or multilateral international agreements and for treatment accorded pursuant to all such future agreements with respect to certain sectors only.[11] The scope of the NAFTA and that of its investment chapter limit its MFN treatment obligation in other areas as well, including, for example, taxation[12] and financial services.[13] The same kind of limitations to the scope of MFN protection appears in the US-Chile and US-Singapore free trade agreements and the recently concluded US-Australia free trade agreement.

Some US and Canadian BITs also contain limitations to the MFN clauses that preclude coverage of the advantages accorded by virtue of multilateral agreements or negotiations (such as the GATT/Uruguay Round) to which their BIT partners may or may not have adhered. Language of this sort (the "GATT exception") appeared for the first time in the Article XII(2)(b) 1990 US-Poland BIT.[14] Another example is article G-8 of the Canada-Chile Agreement which provides that the MFN clause in the investment chapter of that agreement "does not apply to any measure that is an exception to, or derogation from, a Party's obligations under the TRIPS Agreement, as specifically provided for in that agreement".

The Understanding reached by the United States, the European Commission and certain acceding and candidate countries regarding their BITs with the United States on 22 September 2003 describes the means, through individual protocols, of avoiding potential incompatibilities arising from MFN obligations in the BITs and the obligations of membership in the European Union.

Finally, it may be noted that some WTO members have listed substantive provisions in their bilateral investment treaties as involving exemptions to the MFN obligations of the GATS with a view of protecting a higher level of treatment in such BITs in relation to GATS commitments.[15]

GATS Article VI (Economic Integration) does not prevent, however, any of its members from being a party to or entering into an agreement liberalising trade in services between or among the parties to such an agreement, provided that such an agreement meets the conditions set out in paragraph 1 of that article. GATS Article V(6) further provides that a service supplier of any member that is a juridical person constituted under the law of a party to an agreement meeting the conditions of paragraph 1 shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement. Examples of the treatment accorded to enterprises of third party investors in accordance with these provisions is to be found in NAFTA

Articles 1101 and 1139, EC Treaty Articles 43-48, and Annex G of the draft Understanding between the EU and the USA concerning Certain Bilateral Investment Treaties, dated September 22, 2003.

3. International Law Commission Work[16, 17]

In 1964 the International Law Commission (ILC) embarked on a multi-year project to prepare a set of draft articles on the MFN clause.[18] The idea for the project originally arose in the context of the ILC's work on the law of treaties, and, as noted in the introduction to the draft articles, they should be interpreted in light of the Vienna Convention on the Law of Treaties (Vienna Convention).[19] In determining to proceed with the project, the ILC acknowledged the importance of the role of the most-favoured-nation treatment obligation in the sphere of international trade.[20] However, the ILC specifically did not confine its studies to that sphere, but rather explored the application of the clause in as many spheres as possible.[21]

In 1978, the ILC adopted the Draft Articles on Most-Favoured-Nation Clauses and recommended to the General Assembly of the United Nations that they be used for a Convention on the subject. The General Assembly did not act upon this recommendation and took no substantive action on the draft articles.[22] The ILC's work provides, nevertheless, a general analysis of MFN clauses and insight into the "*ejusdem generis*" principle, which has been used in their interpretation in several judicial and arbitral cases, including recent ones.[23, 24] The present section summarises the most general aspects of this work.[25]

3.1. General principles of an MFN clause[26]

In examining the ILC's work, it is important to note first of all that the Draft Articles elaborated by the Commission were intended to be "without prejudice to any provision on which the granting State and the beneficiary State may otherwise agree" (Article 29).[27] Thus, the content of the treatment due in each specific case is defined by the actual language of the MFN clause in question. This text must be interpreted in accordance with the principles of treaty interpretation, as codified in the Vienna Convention. Article 31.1 of the Vienna Convention states that "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".[28]

In the ILC's work, the MFN clause is described as taking the form of a treaty provision whereby a State (the granting State) undertakes an "obligation" towards another State (the beneficiary State) to accord MFN treatment in an agreed sphere of relations and that (beneficiary) State accepts it.[29] The clause may also determine the persons or things to whom and to which the MFN treatment is applicable. Ultimately, the extent of the benefits to which the beneficiary State

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may lay claim (for itself or for persons or things in determined relationship with it) is limited by the treatment extended by the granting State to a third State (or to persons or things in the same relationship with a third State).[30]

The MFN clause may be invoked if the third State (or persons or things in the same relationship with the third State as are the persons or things mentioned in the clause with the beneficiary State) have been extended the favours that constitute the MFN treatment foreseen in the clause. The mere fact of a more favourable treatment is what is required to set in motion the operation of the clause. This treatment may be based upon a treaty, another agreement or a unilateral, legislative or other act or mere practice.[31] The beneficiary State, on the strength of an MFN clause may invoke the clause to also demand the same benefits as were extended to the third State. Depending on the drafting of the MFN clause, the mere fact that the third State has not availed itself of the benefits which were extended to it by the granting State does not absolve the granting State from the obligation under the MFN clause.[32]

When two treaties exist, one between the granting State and the beneficiary State containing the MFN clause, and the other between the granting State and a third State, the treaty that contains the MFN treatment clause is considered to be the "basic" treaty.[33] As was held by the majority of the Court in the landmark *Anglo-Iranian Oil Company case*,[34] "this is the treaty which establishes the juridical link between the beneficiary State and a third party treaty and confers upon that State the rights enjoyed by the third party. A third-party treaty, independent and isolated from the basic treaty, cannot produce any legal effect as between [...] the beneficiary State and [...] the granting State (it is *res inter alios acta*)".[35] The beneficiary is entitled, to the extent provided by the MFN provision under its own treaty, to claim all rights and favours extended by the granting State to the third State. This extension can be seen as "ingenious" legal shorthand to treaty process.[36]

The granting State and the beneficiary State can however limit in the basic treaty the extent of the favours that can be claimed by the beneficiary. If the clause contains a restriction, the beneficiary State cannot claim any favours beyond the limits set by the clause, even if this treatment does not reach the level of the favours extended by the granting State to a third State.[37]

3.2. The **ejusdem generis** *principle*

The *ejusdem generis* principle is the rule according to which a MFN clause can only attract matters belonging to the same subject matter or the same category of subject as to which the clause relates.

Article 9 of the ILC Draft Articles provides that the beneficiary State of a MFN clause should acquire, for itself or for the benefit of persons or things in a determined relationship with it, only those rights which fall within the limits of the subject matter of the MFN clause, and only with respect to persons or things which are specified in the clause or implied from its subject matter to benefit from it. Draft Article 10 goes on to suggest that the rights acquired should be those that the granting State extends to a third State within the limits of the subject matter of the MFN clause and only if the beneficiary persons or things belong to same category of persons or things which benefit from the treatment extended to the third party and have the same relationship with that State.[38]

What subject matter?

The Commentary to Draft Articles 9 and 10 underlines that the rights of the beneficiary are limited, with respect to the subject matter, in two ways, namely by the clause itself, which refers to a certain matter, and secondly by the rights conferred by the granting State on the third State. Although the meaning of the rule is clear, its application is not always easy. The Commission considered the following cases.

In the ***Anglo-Iranian Oil Company case (1952)***[39] – which resulted from the nationalisation by the Government of Iran of the oil industry – the United Kingdom invoked the MFN clauses of the agreements concluded with Iran in 1857 and 1903 to seek the treatment foreseen in the Treaty of Friendship, Establishment of Commerce of 1934 between Iran and Denmark and similar agreements concluded with Switzerland and Turkey in 1934 and 1937 that guaranteed the persons and property of the parties treatment in accordance with international law. The Court dismissed the claim on the basis that it had no jurisdiction.[40]

In the case concerning ***Rights of Nationals by the United States of America in Morocco (1952)***[41] – which dealt in particular with the extent of the consular jurisdiction which the United States could exercise in the French Zone of Morocco and the question of fiscal immunity of US citizens – the International Court of Justice concluded that the United States was not entitled, by virtue of the MFN treatment clauses in its 1836 treaty with Morocco, to exercise consular jurisdictional rights in the French zone of Morocco other than those strictly included in that Agreement. The Court held in this connection that the United States had acquired additional consular jurisdiction by the effect of such MFN clauses, but that those MFN-derived benefits had come to an end with the termination by Great Britain of all its rights and privileges of a capitulatory character by the Franco-British Convention of 1937. The Court also concluded that the MFN clause did not provide the basis for fiscal immunity, given that no other State enjoyed it for the benefit of its nationals.[42] The Court's comments seemed to imply, however, that the scope of the MFN clause in a treaty was confined to the matters dealt with in that Convention.

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In the ***Ambatielos case (1952,[43] 1953,[44] 1956[45])***, the Greek government, relying upon Article X (MFN clause) and Article XV (National treatment) of the Treaty of Commerce and Navigation concluded by Greece and the United Kingdom in 1886 and a Declaration annexed to the Treaty of Commerce and Navigation of 1926, invoked provisions embodied in earlier treaties between the United Kingdom and third States (Denmark, Sweden and Bolivia) to claim that Ambatielos, a Greek ship-owner, had suffered a denial of justice in regard to a dispute it brought before the English courts. By its Judgments of 1 July 1952 and 19 May 1953, the International Court of Justice found that it had jurisdiction to decide whether the United Kingdom was under the obligation to submit to arbitration the difference as to the validity of Ambatielos' claim, in so far as it was based on the Anglo-Hellenic Treaty of 1886. At the same time, the Court held that it had no jurisdiction to go into all the merits of the case. The case was subsequently submitted to a Commission of Arbitration which ultimately rejected the claim, in its Award of 6 March 1956, on the basis that the provisions contained in other Treaties invoked by the Greek government provided for "privileges, favours or immunities" no more favourable than those resulting from the national treatment clause. However, the ILC referred to this case because the Commission of Arbitration said:

> "*The most-favoured-nation clause can only attract matters belonging to the same category of subject as that to which the clause itself relates.*" *Regarding the specifics of the case, it held that:* "*… It is true that the 'administration of justice', when viewed in isolation is a subject-matter other than 'commerce and navigation', but this is not necessarily so when it is viewed in connection with the protection of the rights of traders. Protection of the rights of traders naturally finds a place among the matters dealt with by Treaties of commerce and navigation. … Therefore it cannot be said the administration of justice, in so far as it is concerned with the protection of these rights, must necessarily be excluded from the application of the most-favoured-nation clause, when the latter includes 'all matters relating to commerce and navigation'.*"[46]

The International Law Commission also relied on decisions of national courts.[47] In a 1913 ***French case***,[48] the French Court of Cassation decided against the invocation of certain procedural requirements for bringing suit found in a French-Swiss Convention on jurisdiction and execution of judgment, in favour of German nationals as a result of an MFN clause in an 1871 Franco-German commercial treaty applying to the "admission and treatment of subjects of the two nations". The Court concluded that "these MFN provisions pertain exclusively to the commercial relations between France and Germany, considered from the point of view of the rights under international law, and that they do not concern the rights under civil law and that 'the most-favoured-nation clause may be invoked only if the subject of the treaty stipulating it is the same as the particularly favourable treaty the benefit of which is claimed'".

In ***Lloyds Bank v. de Ricqlès and Gaillard (1930)***,[49] the Commercial Tribunal of the Seine dismissed a claim by Lloyds Bank, which having been ordered to give security for costs, invoked Article I of the Anglo-French Convention regulating commercial maritime relations of 28 February 1882 to benefit from the provisions of a Franco-Swiss Treaty of 15 June 1889, which gave Swiss nationals the right to sue in France without being required to give security for costs. Lloyds argued that Article I of the Anglo-Convention engaged the parties to give each other "immediately and unconditionally the benefit of every favour, immunity or privilege in matters of commerce and industry which have been conceded by one [of] the parties to any third nation whatsoever, whether within or beyond Europe". The Tribunal held that a party to a convention of a general character such as the Anglo-French Convention could not claim the MFN clause the benefits of a special convention such as the Franco-Swiss Convention, which dealt with one particular subject, namely freedom from the obligation to give security for costs.[50]

In reference to this case, the International Law Commission suggested that, under the reasoning of this case, there would be a dilemma facing the drafters of an MFN clause of either drafting the clause in too general terms, risking the loss of its effectiveness through a strict interpretation of the *ejusdem generis* rule, or of drafting it too explicitly, enumerating its specific domains, in which cases the risk consists in the possible incompleteness of the enumeration.[51]

The ILC Commentary stated that it is only the subject-matter of the clause, not the treaty or agreement containing the clause that must belong to the same category. In other words, it is not necessary that the treaty or agreement including the clause be of the same category as that of the benefits that are claimed under the clause. To hold otherwise would seriously diminish the value of the MFN clause. However, the text of the treaty including the MFN clause does serve as part of the context for its interpretation under Article 31(1) of the Vienna Convention on the Law of Treaties.

In its Commentary (11) to Draft Articles 9 and 10, the Commission observed that, since the effect of the MFN process is, by means of the provisions of one treaty, to attract those of another, unless this process is strictly limited to cases where there is a substantial identity between the subject matter of the two sets of clauses concerned, the result could be to impose upon the granting State obligations it never contemplated.

What categories of persons or things?

A similar reasoning was proposed by the Commission for gauging the application of the MFN treatment to particular categories of persons or things. In essence, the beneficiary State may claim MFN treatment only for the

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category of persons or things that receives or is entitled to receive certain treatment or certain favour, under the right of a third State. Furthermore, the persons or things in respect of which the MFN treatment is claimed must be in the same relationship with the beneficiary State as are the comparable persons or things with the third States.[52] There are cases where the MFN clause is silent on the persons or things that may benefit from it. In such case, the ILC suggests, the subject matter of the clause – for instance customs duties, commerce, shipping, – would implicitly determine the class of persons or things that can benefit from it – importers, merchants, vessels.[53]

4. Recent cases

Among the numerous cases brought to ICSID in recent years,[54] two cases, ***Maffezini v. Kingdom of Spain*** and ***Tecnicas MedioAmbientales Tecmed S.A. v. the United Mexican States*** stand out as raising issues concerning the MFN clause. None of the investor-State claims brought under NAFTA Chapter Eleven has resulted in a finding of a breach of the MFN clauses.

4.1. BITs

Maffezini v. Spain

Maffezini v. Kingdom of Spain (2000)[55] concerned a dispute arising from the treatment allegedly received by the Argentine investor Emilio Agustin Maffezini from Spanish entities, in connection with his investment in an enterprise for the production and distribution of chemical products in the Spanish region of Galicia. Spain (the Respondent) objected to the tribunal's jurisdiction since Mr. Maffezini (the Claimant) had failed to comply with an exhaustion of local remedies requirements set forth in the Argentine-Spain BIT. Mr. Maffezini admitted that the dispute had not been referred to the Spanish courts prior to its submission to ICSID, but he argued that the MFN clause in the Argentine-Spain BIT would allow him to invoke Spain's acceptance of ICSID arbitration contained in the Chile-Spain BIT and that none of the exceptions from MFN in the Argentine-Spain BIT applied to the dispute settlement provisions at issue in the case.

On 25 January 2000, the Tribunal decided that,[56] by virtue of the MFN clause of the 1991 Argentine-Spain Bilateral Investment Treaty, the claimant had the right to import the more favourable jurisdictional provisions of the 1991 Chile-Spain Agreement and, as a result, to resort to international arbitration without being obliged to submit its dispute to Spanish courts for a period of eighteen months beforehand.[57] Paragraph 2 of Article IV of the

Argentina/Spain BIT provides that after guaranteeing a fair and equitable treatment for investors (paragraph 1):

> "*In all matters subject to this Agreement, this treatment shall be no less favourable than that extended by each Party to the investments made in its territory by investors of a third country.*"[58]

In this connection, the Tribunal referred to the *ejusdem generis* principle[59] and the reasoning found in the *Ambatielos* case (namely that the MFN clause can apply to provisions concerning the "administration of justice"). The Tribunal also stated that today's dispute settlement arrangements are "inextricably related" to the protection of foreign investors as shown below:

> *"Notwithstanding the fact that the basic treaty containing the clause does not refer expressly to dispute settlement as covered by the most favoured nation clause, the Tribunal considers that there are good reasons to conclude that today dispute settlement arrangements are inextricably related to the protection of foreign investors, as they are also related to the protection of rights of traders under treaties of commerce. Consular jurisdiction in the past, like other forms of extraterritorial jurisdiction, were considered essential for the protection of rights of traders and, hence, were regarded not merely as procedural devices but as arrangements designed to better protect the rights of such persons abroad.*[60] *It follows that such arrangements, even if not strictly a part of the material aspect of the trade and investment policy pursued by treaties of commerce and navigation, were essential for the adequate protection of the rights they sought to guarantee.*
>
> *International arbitration and other dispute settlement arrangements have replaced these older and frequently abusive practices of the past. These modern developments are essential, however, to the protection of the rights envisaged under the pertinent treaties; they are closely linked to the material aspects of the treatment accorded…."*

The Tribunal concluded that:

> "*… if a third-party treaty contains provisions for the settlement of disputes that are more favourable to the protection of the investor's rights and interests than those in the basic treaty, such provisions may be extended to the beneficiary of the most favoured nation clause as they are fully compatible with the ejusdem generis principle…*"[61]

Under the broad MFN clause of the Argentine-Spain treaty, which expressly referred to "all matters subject to the Agreement"[62] the Tribunal did not accept the respondent's claim that "under the principle *ejusdem generis* the most favoured nation clause can only operate in respect to… substantive matters or material aspects of the treatment granted to investors and not to procedural or jurisdictional questions".[63]

In rendering its decision, the Tribunal observed that in some BITs the MFN clause explicitly embraces the provisions on dispute settlement.[64] In other treaties it refers to all rights contained in the agreement without mentioning dispute settlement.[65]

However, the Tribunal stated the following limits to its interpretation of the clause:

> *"… As a matter of principle, the beneficiary of the clause should not be able to override public policy considerations that the contracting parties might not have envisaged as fundamental conditions for their acceptance of the agreement in questions, particularly if the beneficiary is a private investor…*
>
> *Here it is possible to envisage a number of situations not present in the instant case. First, if one contracting party has conditioned its consent to arbitration on the exhaustion of local remedies, which the ICSID Convention allows, this requirement could not be bypassed by invoking the most favoured nation clause in relation to a third-party agreement that does not contain this element since the stipulated condition reflects a fundamental rule of international law. Second, if the parties have agreed to a dispute settlement arrangement which includes the so-called fork in the road, that is, a choice between submission to domestic courts or to international arbitration, and where the choice once made becomes final and irreversible, this stipulation cannot be bypassed by invoking the clause. This conclusion is compelled by the consideration that it would upset the finality of arrangements that many countries deem important as a matter of public policy. Third, if the agreement provides for a particular arbitration forum, such as ICSID, for example, this option cannot be changed by invoking the clause, in order to refer the dispute to a different system of arbitration. Finally, if the parties have agreed to a highly institutionalized system of arbitration that incorporates precise rules of procedure, which is the case, for example, with regard to the North America Free Trade Agreement and similar arrangements, it is clear that neither of these mechanisms could be altered by the operation of the clause because these very specific provisions reflect the precise will of the contracting parties. Other elements of public policy limiting the operation of the clause will no doubt be identified by the parties or tribunals. It is clear, in any event, that a distinction has to be made between the legitimate extension of rights and benefits by means of the operation of the clause, on the one hand, and disruptive treaty-shopping that would play havoc with the policy objectives of underlying specific treaty provisions, on the other hand."*[66]

Tecmed v. Mexico[67, 68]

In this case, decided on 29 May 2003, the Respondent was found to have breached its obligations under the 1996 Mexico/Spain BIT as set forth in Articles 4(1) (Fair and Equitable Treatment) and 5(1) (Nationalisation and

Expropriation) in respect to the Mexican government's failure to re-license the Spanish investor Tecmed's hazardous waste "Cytrar" in the state of Sonora. In considering the challenges made to the Arbitral Tribunal's jurisdiction and the timely submission by the Claimant of some of its claims, however, the Tribunal was called upon to decide whether the "most favourable conditions" foreseen in Article 8(1) of the Agreement entitled the claimant to a retroactive application of its claim in view of a more favourable treatment in connection with that matter which would be afforded to an Austrian investor under the Austria/Mexico BIT of 29 June 1998. This article reads:[69]

"*If the provisions of law of one of the Contracting Parties or obligations under international law at the margins of the present Agreement, current or future, between the Contracting Parties, result in a general or specific regulation according to which it should be given to investments of investor of the other Contracting Party, a treatment more favourable than that it is envisaged in the present Agreement, such regulation shall prevail over the present Agreement, to the extent that it is more favourable.*"[70]

In arguing for this result, the claimant referred to the *Maffezini* judgment. The Tribunal did not examine the provisions of the Austria/Mexico BIT or the MFN provisions of the Mexico-Spain BIT and, referring to paragraphs 62 and 63 of *Maffezini*, discussed above, it specifically ruled that:

"*… matters relating to the application over time of the Agreement, which involve more the time dimension of application of its substantive provisions rather than matters of procedure or jurisdiction, due to their significance and importance, go to the core of matters that must be deemed to be specifically negotiated by the Contracting Parties (underlined added). These are determining factors for their acceptance of the Agreement, as they are directly linked to the identification of the substantive protection regime applicable to the foreign investor, and particularly, to the general (national or international) legal context within which such regime operates, as well as to the access of the foreign investor to the substantive provisions of such regime. Their application cannot therefore be impaired by the principle contained in the most favoured national clause.*"[71]

Similarly, the Tribunal found that Title II (4) and (5) of the Appendix to the Mexico/Spain Agreement (relating to dispute settlement):

"*… contains requirements relating to the substantive admissibility of claims by the foreign investor, i.e. its access to the substantive protection regime contemplated under the Agreement. Consequently, such requirements are necessarily a part of the essential core of negotiations of the Contracting Parties; it should therefore be presumed that they would not have entered into the Agreement in the absence of such provisions. Such provisions, in the opinion of the Arbitral Tribunal, therefore fall outside the scope of the most favoured nation clause contained in Article 8(1) of the Agreement.*"[72]

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In considering the substantive merits of the case, the Tribunal found no violation of the MFN clause of the Agreement.[73]

4.2. NAFTA

Two claimants under NAFTA's investment chapter have relied on MFN provisions. In the final awards of both cases, however, the tribunals rejected the applicability of these MFN provisions. As a result, neither case illuminates the principle subject of this article, *i.e.*, the operation of MFN clauses.

ADF v. United States of America (2002)

The ADF case is the only completed NAFTA claim in which the claimant alleged a breach of the MFN treatment clause, Article 1103. According to the Tribunal's 9 January 2003 award, ADF's Article 1103 claim was an attempt to mitigate the impact of the NAFTA Free Trade Commission's (FTC's) Interpretation on the Article 1105 claim.[74] However, the Tribunal dismissed the Article 1103 claim. It found that, pursuant to Article 1108(7)(a), the MFN article did not apply to ADF's claim because the case involved government procurement.[75] As a result, the tribunal did not engage in a rigorous analysis of ADF's Article 1103 claim.

Pope and Talbot Inc. v. Canada (2001, 2002)

In Pope and Talbot, the claimant did not allege a breach of Article 1103, but rather a breach of Article 1105. However, the Final Merits Award of Pope and Talbot rendered on 10 April 2001 suggested that an MFN clause could lead to import into the NAFTA what the tribunal described as more favourable "fair and equitable treatment" provisions contained in some BITs.[76] The Tribunal then observed that this formulation entitles investors to fair and equitable treatment without regard to any limitations inherent in international law since these agreements provided that "investors must at all times be accorded fair and equitable treatment… and shall in no case be accorded treatment less than required by international law". The Tribunal then considered that, because NAFTA investors could benefit from this more favourable treatment by virtue of Article 1103, it would make no sense for NAFTA Parties to deny those rights under Article 1105 only to find them revived pursuant to Article 1103. The Tribunal also stated that the NAFTA Parties were unlikely to have intended, in Article 1105, to treat each other's investors less favourably than those from other countries.[77] On that basis, the Tribunal found a violation of Article 1105.

Shortly after the issuance of the Merits Award, the NAFTA Free Trade Commission (FTC) issued a binding interpretive note on Article 1105.[78] This was followed some months later by the Tribunal's issuance of the Damages

Award. In that award, the Tribunal accepted, as a working basis,[79] the FTC interpretation, which clarified that Article 1105 does not require treatment in addition to or beyond that which is required by customary international law minimum standard of treatment, but maintained its prior award in favour of the claimant, concluding that Article 1105 was breached even under the FTC's interpretation. The Tribunal, however, found it "unnecessary to consider issues relating to Articles 1102 or 1103 which had been raised following upon the Interpretation."[80]

The Pope and Talbot Tribunal's reasoning in the merits phase has not been followed in subsequent NAFTA cases.[81]

5. Summing up

The main points in the present Note may be summarised as follows:

- MFN treatment has long been a core standard of international economic relations. It provides for equal competitive opportunities between nations in respect to the matters to which the particular MFN clause applies, be they in the field of trade, investment, or any field of economic co-operation. Although its application to international investment is more recent than that for international trade, it is widely accepted, together with national treatment, as one of the most important standards of treatment for investors and their investments.
- Despite their prevalence in investment treaties, MFN clauses do not have a universal meaning. Indeed, the formulation and application of MFN clauses varies widely among investment treaties. In some cases, the scope of application of the clauses extends to the entire content of the treaty; in others, the clause is limited to only some of the matters addressed by the treaty. The proper application and interpretation of a particular MFN clause in a particular case requires a careful examination of the text of that provision undertaken in accordance with the treaty interpretation rules as set out in the Vienna Convention.
- The *ejusdem generis* principle has been applied in the jurisprudence of international tribunals and national courts and by diplomatic practice. According to this principle, an MFN clause can attract the more favourable treatment available in other treaties only in regard to the same "subject matter", the same "category of matter" or the same "class of matter". While the principle is clear, its application is not always simple or consistent. This principle can provide some useful guidance. However the interpretation and application of a particular MFN clause must be undertaken, as noted above, based on the text of the provision and according to the general rules of interpretation as embodied in the Vienna Convention.

Notes

1. The International Law Commission (ILC) has defined MFN treatment as follows: "Most-favoured-nation treatment is a treatment accorded by the granting State to the beneficiary State, or to persons or things in a determined relationship with that State, not less favourable than treatment extended by the granting State or to a third State or to persons or things in the same relationship with that third State", Article 5 of the Draft articles on most-favoured-nation clauses (ILC Draft), in *Yearbook of the international Law Commission*, 1978, Vol. II, Part Two, p. 21.
2. See, especially, the comments of some socialist countries in "Comments of member States, organs of the United Nations, specialized agencies and other intergovernmental organizations on the draft articles on the most-favoured-nation clause adopted by the International Law Commission at its twenty-eighth session", in *Yearbook of the International Law Commission*, 1978, Vol. II, Part Two, p. 162 ff.
3. See Article 7 of the ILC Draft, the related comments and the doctrine here referred to, *Ibidem*, p. 24 ff. See also *Oppenheim's International Law*, edited by R. Jennings and A. Watts, and Vol. I, Harlow, 1992, p. 1326 f.
4. For a thorough history of the MFN clause up to the Second World War, including the work done by, or under the auspices of, the League of Nations, see the First Report of the ILC's Special Rapporteur, *Yearbook of the International Law Commission*, 1969, Vol. II, p. 157 ff.
5. Treaty of Amity and Commerce, February 6, 1778, France-United States, Articles 3, 8 Stat. 12 ("The Subjects of the most Christian King shall pay in the Ports, Havens, Roads, Countries, Islands, Cities or Towns, of the United States or in any part of them, no other or greater Duties or Imposts… than those which the Nations most favoured are or shall be obliged to pay; and they shall enjoy all the Rights, Liberties, Privileges, Immunities and Exemptions in Trade, Navigation and Commerce… which the said Nations do or shall enjoy."); *see also id.* Article 4 (similar provision with respect to US nationals in France).
6. United Nations Conference on Trade and Employment, Final Act and Related Documents, April 1948, Article 12 (*International Investment for Economic Development and Reconstruction*), paragraph 2(a)(ii).
7. Of all the WTO Agreements, the General Agreement on Trade in Services (GATS) is generally considered as dealing more directly with investment issues. Mode 3 applies to the supply of trade in services through "commercial presence", which is in essence an investment activity.
8. The final draft text of the US-Central America Free Trade Agreement (CAFTA) resulting from the negotiations concluded in December 2003 and dated 28 January 2004 contains an interpretation footnote on the scope of application of the MFN treatment clause in the Investment Chapter of the Agreement (Chapter 10) which reads:
   "The Parties note the recent decision of the arbitral tribunal in Maffezini (Arg.) v. Kingdom of Spain, which found an unusually broad most-favoured-nation clause in an Argentina-Spain agreement to encompass international dispute resolution procedures. See Decision of Jurisdiction, paragraphs 38-64 (January 25, 2000), reprinted in 16 ICSID Rev. F.I.L.J. 212(2002). By contrast the Most-Favoured-Nation Treatment Article of this Agreement is expressly limited in scope to matters 'with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments'. The Parties share the understanding and intent that this clause does not encompass international dispute resolution mechanisms such as those contained in Section C of this

chapter, and therefore could not reasonably lead to a conclusion similar to that of the Maffezini case."

This footnote would be deleted in the final text of the Agreement but the Parties agreed that it is to be included in the negotiating history as a reflection of the Parties' shared understanding of the Most-Favoured-Treatment Article and the Maffezini case.

The draft text of CAFTA is currently subject to legal review for accuracy, clarity and consistency. Under the Trade Act of 1992, the Administration must notify Congress at least 90 days before signing the Agreement. The Administration expects to notify Congress in the near future of its intent to sign the CAFTA. See *www.ustr.gov/releases/2003/12/03-82.pdf*.

9. *www.ustr.gov/new/fta/chile.htm*. This agreement entered into force on 1 January 2004.

10. *www.ustr.gov/new/fta/Singapore/final.htm*. This agreement entered into force on 1 January 2004.

11. These MFN exceptions apply notably to: *a)* international agreements in force or signed prior to the entry into force of the NAFTA; and *b)* international agreements in force or signed after the date of the entry into force of NAFTA in the areas of aviation, fisheries, maritime matters, telecommunications networks and transport services (except for measures covered by the Telecommunications chapter of NAFTA or to the production, sale, licensing or radio or televisions programming); as well as *c)* certain state measures or aid programmes.

12. See NAFTA Article 2103 ("Except as set out in this article, nothing in this Agreement shall apply to taxation measures").

13. See NAFTA Article 1101(3) ["This Chapter does not apply to measures adopted or maintained by a Party to the extent that they are covered by Chapter Fourteen (Financial Services)"].

14. Kenneth J. Vandevelde, US Bilateral Investment Agreements, the Second Wave, in Michigan Journal of International Law, Summer 1993, p. 15.

15. Costa Rica has reserved for all sectors, "measures granted under bilateral treaties for the promotion and protection of investment designed to encourage in a preferential manner the investments of certain countries covered by such agreements". Jordan has notified that "measures extending preferential treatment are pursuant to bilateral investment treaties". Kuwait extends the exemption to multilateral agreements related to the promotion and protection of investment by notifying "measures taken to promote and protect investments applied in conformity with bilateral, multilateral agreements and undertakings to which Kuwait is a party". Poland has notified provisions on "commercial presence contained in promotion and protection of foreign investments agreements that go beyond limitations embodied in Poland's schedule of specific commitments. Trinidad and Tobago pre-empted all existing and future bilateral investment and protection treaties. The United Sates has an MFN exemption for BIT entry and stay obligations pertaining to the movement of personnel". Uruguay has notified as measure inconsistent with Article II "the provisions of bilateral investment promotion and protection agreements which guarantee investors from the other contracting party freedom to transfer and invest capital and any other sum related to investments, and also guarantee investors against the non-commercial risks to which their investment is exposed". Singapore has also listed exemptions for preferential treatment resulting from Investment Guarantees Agreements.

Canada, Chile and Poland have, in addition, invoked an exemption for procedural measures in their BITs. Chile's exemption concerning measures establishing dispute settlement procedures contained in existing or future bilateral treaties on the protection of investment applies in principle to all countries. Canada and Poland indicated that they "accept compulsory arbitration of investor/state investment disputes brought by or in respect of service suppliers of countries with which Canada/ Poland have or may have agreements providing for such procedure".

In some other cases, country exemptions to Article II of GATS refer to preferential treatment under sectoral or regional agreements. Bulgaria has notified an MFN exemption for present and future bilateral agreements concerning the provision of legal services through established presence; Thailand for the investment provisions in the bilateral Treaty of Amity and Economic Relations with the United States; and Venezuela for bilateral agreements relating to petroleum-related services.

With regard to regional agreements, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama and Venezuela have notified entries for preferences accorded under the General Treaty of Central American Economic Integration; Côte d'Ivoire for preferences for insurance firms based in signatories of the CIMA and preferences for financial service providers based in WAEMU member States; Cyprus for market access restrictions for firms based in the EU and EFTA countries; EC 12 for existing and future Euro-Med agreements; Finland, Iceland, Norway, Sweden for measures aimed at promoting Nordic co-operation; Pakistan for favourable treatment for financial institutions set up to undertake Islamic financing transactions; Senegal for preferences accorded to insurance and financial service providers based in signatories to ECOWAS, WAEMU and WAMU; South Africa for an exemption on exchange controls for persons based in the CMA; and the United Arab Emirates for preferential treatment for service providers based in members of the Gulf Co-operation Council.

16. The following section is drawn from the *Report of the International Law Commission to the General Assembly on the Work of Its Thirtieth Session*, [1978], Yearbook of the International Law Commission, A/CN.4/SER.A/1978/Add.1 (Part 2) ("ILC Report") and "Most-Favoured-Nation Clause", Yearbook of the International Law Commission, 1970, Vol. II, pp. 201-213.

17. The International Law Commission was established by the General Assembly in 1947 to promote the progressive development of international law and its codification. The Commission, which meets annually, is composed of 34 members who are elected by the General Assembly for five-year terms and who serve in their individual capacity, not as representatives of their Governments. Most of the Commission's work involves the preparation of drafts on topics of international law. Some topics are chosen by the Commission and others referred to it by the General Assembly or the Economic and Social Council. When the Commission completes draft articles on a particular topic, the General Assembly usually convenes an international conference of plenipotentiaries to incorporate the draft articles into a convention which is then open to States to become parties: *www.un.org/law/ilc*.

18. See Introduction to the 1978 ILC Report, paragraph 15.

19. *Idem* paragraph 59.

20. *Idem* paragraph 17.

21. *Idem* paragraph 61.

22. See the following acts of the General Assembly: Res. 33/139 (1978), 35/161 (1980), and 40/65 (1985), and Decision 43/429 (1988).

23. The ILC's work has been regarded by some countries as reflecting international law. See, for example, the comments of Colombia, Netherlands, Sweden in "Comments of member States, organs of the United Nations, specialised agencies and other intergovernmental organisations on the draft articles on the

most-favoured-nation clause adopted by the International Law Commission at its twenty-eighth session", in *Yearbook of the International Law Commission*, 1978, Vol. II, Part Two, and Germany in "Analytical compilation of comments and observations from Governments, organs of the United Nations which have competence in the subject-matter and interested intergovernmental organizations: report of the Secretary-General", UN A/35/443, p. 9. However, it should be borne in mind that to grant MFN treatment is not an obligation of customary international law.

24. Some OECD member countries, without denying the relevance of the ILC exercise, stressed that the peculiarities of each MFN clause and of its context put into serious question the utility of codification through a Convention. See, for example, the comments by Luxembourg, in "Comments of member States, organs of the United Nations, specialised agencies and other intergovernmental organisations on the draft articles on the most-favoured-nation clause adopted by the International Law Commission at its twenty-eighth session", in *Yearbook of the International Law Commission*, 1978, Vol. II, Part Two, p. 168 ff, or by the UK in "Analytical compilation of comments and observations from Governments, organs of the United Nations which have competence in the subject-matter and interested intergovernmental organisations: report of the Secretary-General", UN A/35/443, p. 11. Other countries, for example the United States, supported the Commission's draft articles and favoured their adoption by the Commission, but they took position against their final codification through an international convention (see *ibidem*, p. 14).

25. While the ILC studied practically all aspects of the MFN treatment clauses including the issues of exceptions, and termination or suspension of MFN rights, the present section focuses on the general interpretation of MFN clauses.

26. Unless otherwise stated, paragraphs 24-47 reproduce the views of the ILC.

27. In this sense, see also *Oppenheim's International Law*, *op. cit*., p. 1328.

28. In Article 31.2, the word "context" is held to include the preamble and annexes of the treaty as well as any agreement or instrument made by the parties in connexion with the conclusion of the treaty. Article 31.3 further states that there shall be taken into account, together with the context, any subsequent agreement or practice relating to the treaty together with any relevant rules of international law. According to Article 31.4, a special meaning can also be given to a term "if it is established that the parties so intended". Where the interpretation according to the provisions of Article 31 needs confirmation, or determination since the meaning is ambiguous or obscure or leads to a manifestly absurd or unreasonable result, recourse can be made to the supplementary means of interpretation under Article 32. These means include the preparatory works (*travaux préparatoires*) of the treaty and the circumstances of its conclusion. The Annex 5.A1 reproduces the text of Articles 31 and 32 in full.

29. Usually, the beneficiary State also makes an MFN pledge in a reciprocal way. See *Idem* Article 4 and Commentary (5).

30. *Idem* Article 8(2), and Commentary (1).

31. *Idem* Article 8, Commentary (1).

32. *Idem* Article 5, Commentary (5).

33. *Idem* Article 8, Commentary (1).

34. *Anglo-Iranian Oil Co. case (Preliminary objection), Judgment of 22 July 1952 (I.C.J. Reports 1952, p. 109).* The decision of the Court contributed greatly to the clarification of the legal theory. Before the Court's decision, several legal writers presented the

operation of the MFN treatment clause as an exception to the rule *pacta tertiis nec nocent nec prosunt* (*i.e.* that treaties produce effects only as between the contracting parties). Legal theory is now unanimous in endorsing the findings of the majority of the Court in the *Anglo-Iranian* case. As the ILC said, rather than being an exception to this rule, it confirms it, see *ILC Report*, Article 8, Commentary (2).

35. *Idem* Article 8, Commentary (2).

36. G. Schwarzenberger also wrote regarding the relation between the *pacta tertiis* rule and the MFN clause: "This drafting device… contributes greatly to the rationalization of the treaty-making process and leads to the automatic self-revision of treaties which are based on the most-favoured-nation standard. It makes unnecessary the incorporation in the treaty between grantor and the beneficiary of the most-favoured-nation treatment of any of the relevant treaties between the grantor and third States and their deletion whenever such treaties cease to be in force. So long as this last-mentioned aspect of the matter is kept in mind, most-favoured-nation clauses are correctly described as drafting (and deletion) by reference". G. Schwarzenberger, *International Law as applied by International Courts and Tribunals*, London, 3rd ed, 1957, p. 243 and *Yearbook of the International Law Commission*, 1970, Vol. II, p. 204.

37. ILC Report, Article 8, Commentary (8).

38. *Idem* p. 26.

39. ICJ Reports, 1952, p. 93 and *www.icj-cij.org/icjwww/idecisions/isummaries/ifussummary*.

40. The Court found that it would have had jurisdiction only when a dispute related to the application of a treaty or convention concluded by Iran after its Declaration of acceptance of the jurisdiction of the Court, under Article 36(2) of its Statute. This Declaration was made on 19 September 1932, *i.e.* after the UK/Agreements of 1857 and 1903. This case was, nevertheless, mentioned by the ILC because it analysed MFN clauses by comparing the rights of a beneficiary State under a basic agreement with a granting State, with those provided by the granting State to third States.

41. Morocco Case (France v. USA), ICJ *Pleadings*, 1952, Vol. I.

42. The United States invoked the Peace Treaty between Morocco and the United Sates of 1836. That treaty dealt with a variety of matters including navigation, trade and consular jurisdiction. It explicitly provided for the United States consular jurisdiction in all disputes between United States citizens or protégés. The United States claimed additional rights to consular jurisdiction on the basis of an MFN clause in that Treaty, for all cases in which a United States citizen or protégé was merely a defendant. The third party treaties of Morocco, invoked by the United States, were the General Treaty with Great Britain of 1856 and the Treaty of Commerce and Navigation with Spain of 1861. These treaties granted jurisdiction in all cases in which the respective nationals were merely defendants. The Court found that "the United States acquired by virtue of the most-favoured nation clauses, civil and criminal jurisdiction in all cases in which the United States were defendants", but that those jurisdictional benefits were extinguished upon termination by Spain and Great Britain of their respective treaties with Morocco. See *www.icj-cij.org/icjwww/idecisions/isummaries/ifussummary520827.htm*. The full text of the treaty is available at *www.yale.edu/lawweb/avalon/diplomacy/barbary/bar1836t.htm*.

43. IC.J Reports 1952.

44. ICJ Reports 1953.

45. United Nations, *Reports of International Arbitral Awards*, Vol. XII, United Nations, 1963.

46. The submissions of the parties and the opinions expressed in this case also provide useful insights into the operation of the MFN clause and the *ejusdem generis* rule. For instance, in invoking this principle, the counsel for the United Kingdom stated that "the clauses conferring most favoured nation rights in respect of a certain matter, or class of matter, can only attract the rights conferred by other treaties in regard to the same matter of class of matter… This furnishes the conclusive answer to any suggestion that Article X can attract any provisions in other treaties except provisions about commerce and navigation. It cannot attract provisions dealing with the administration of justice and related matters". The Counsel of Greece argued on the other hand that access to the courts and administration of justice in commercial matters is not outside the "genus" of the favours referred to in the MFN clause of the Greek/UK treaty. They are part of "in all matters relating to commerce". See Yearbook of the International Law Commission, 1970, Vol. II, paragraph 69.
47. See "Digest of decisions of national courts relating to the most-favoured-nation clause", prepared by the UN Secretariat for the ILC, A/CN.4/269, 29 March 1973.
48. This description is drawn from the ILC Report, Article 10, Commentary (4).
49. This summary of the case is based on the ILC Report, Article 10, Commentary (5).
50. In other words, in this case as well as the previous one, the Tribunals adopted the view that MFN clauses could not be invoked to compare treatment provided under two treaties dealing with different subjects.
51. *Idem* Commentary (6) to Articles 9 and 10.
52. *Idem* Commentary (15) to Articles 9 and 10.
53. *Supra* note 18, p. 27.
54. By the latest account, 32 new cases have been registered by the Centre in 2003 and 13 in 2004, as compared to 15 such claims in 2002 and only 12 and 5 in 2001 and 2000.
55. Emilio Agustin Maffezini v. Kingdom of Spain (ICSID No. Apr/97/7), Decision on Jurisdiction of 25 January 2000 and Award of the Tribunal of 13 November 2000. These decisions are available at *www.worldbank.org/icsid/cases*.
56. Decision on Jurisdiction of 25 January 2000, *www.worldbank.org/icsid/cases/emilio_DecisiononJurisdiction.pdf*.
57. The Tribunal noted that the Argentine-Spain BIT provides domestic courts with the opportunity to deal with a dispute for a period of eighteen months before it may be submitted to arbitration. Article 10(2) of the Chile-Spain BIT, however, imposes no such condition. It provides merely that the investor can opt for arbitration after the six-month period allowed for negotiations has expired. See *supra* note at paragraph 40.
58. *Idem* at paragraph 38. The Spanish original of the clause reads as follows: "En todas la materias regidas por el presente Acuerdo, este tratamiento no sera menos favorable que el ortorgado por cada Parte a las inversions realizadas en su territorio por inversores de un tercer pais."
59. *Idem* at paragraph 56.
60. Footnote omitted.
61. *Supra* note 58 at 56.
62. The Tribunal also referred to the 1992 Agreement between Chile and the Belgian-Luxembourg Economic Union as an example of other MFN treaty clauses applying to "all rights contained in the present Agreement". *Supra* Note 57 at 53, footnote 21.

63. *Idem* at 15.

64. The Tribunal cited in this connection the investment treaties concluded by the United Kingdom. See also paragraph 11 above.

65. *Idem* at paragraphs 52 and 53.

66. At pp. 23-24. Footnotes omitted.

67. Técnicas Medioambientales Tecmed, SA v. United Mexican States [ICSID Case No. ARB(AF)/00/2] *www.worldbank.org/icsid/cases/laudo-051903%20-English.pdf*.

68. It has also been reported that the German investor claimant in Siemens AG v. Argentine Republic, ICSID case No. ARB/02/08 may also use the Mafezzini construction in this case. See "Investor-State Arbitration: A Hot Issue in Latin America, Guido Santiago Tawil", M. and M. Bomchil, Buenos Aires. Horacio D. Rosatti makes a similar observation on the implications of the Mafezzini case in "*Bilateral Investment Treaties, Binding International Arbitration and the Argentine Constitutional System*", in *La Ley, 15 October 2003*.

69. Article 8(1) is a separate article from the MFN treatment clause in Article 4(2) of the Agreement.

70. The Spanish original of the clause is as follows: "1. Si de las disposiciones legales de una de las Partes Contratantes, o de las obligaciones emanadas del Derecho Internacional al margen del presente Acuerdo, actuales o futuras, entre las Partes Contratantes, resultare una reglamentación general o especial en virtud de la cual deba concederse a las inversiones de inversores de la otra Parte Contratante un trato más favorable que el previsto en el presente Acuerdo, dicha reglamentación prevalecerá sobre el presente Acuerdo, en cuanto sea más favorable."

71. Paragraph 69 ends with a footnote making a cross reference to paragraphs 25-26 and 62-63 of the Maffezini Decision on Jurisdiction.

72. *Idem* p. 24, paragraph 74.

73. "The Claimant has failed to furnish convincing or sufficient evidence to prove, at least *prima facie*, that the Claimant's investment received, under similar circumstances, less favourable treatment than that afforded to nationals of the State receiving the investment of a third State, or that said investment was subject to discriminatory treatment upon the basis of considerations relative to nationality or origin of the investment or the investor."*Ibid*., p. 73, paragraph 181.

74. *ADF Group Inc. v. United States of America (Award, 9 January 2003),* paragraph 136. *www.state.gov/documents/organization/16586.pdf*.

75. *Idem* paragraph 196.

76. See *Pope and Talbot Inc. v. Government of Canada (Tribunal Decision – 10 April 2001)*, paragraphs 111, 115. The Tribunal appears to have relied on the BITs of "at least Canada and the United States". However it did not cite in the award any provisions of Canadian BITs or any secondary sources that cite Canadian FIPA provisions while the US BITs that it cited predated the NAFTA. *www.dfait-maeci.gc.ca/tna-nac/documents/Award_Merits-e.pdf*. Since both the USA and Canada have taken exceptions from MFN for all prior agreements, (NAFTA Annex IV), it is not clear how prior BITs of the United States could be relevant to interpreting the MFN clause in relation to Canada.

77. *Idem* paragraphs 105-118.

78. Paragraph 2 of the FTC's Interpretation provides that the concepts of "fair and equitable treatment" and "full protection and security" do not require treatment in addition to or beyond that which is required by customary international law minimum standard of treatment. Paragraph 3 states that a determination that there has been a breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a breach of Article 1105.

79. While the Tribunal noted that "it might appear" that its own interpretation was different from the one adopted by the FTC, it concluded that even applying this "restrictive interpretation" to the facts of the case, would lead to the exact same conclusions it reached in its previous Award. See *Pope and Talbot Inc. v. Government of Canada (Tribunal Decision – 31 May 2002, at 47, 56 and 69 www.dfait-maeci.gc.ca/tna-nac/documents/damage_award.pdf*.

80. *Idem* at 66.

81. In the *Loewen* case, the Tribunal said that, to the extent that the *Pope and Talbot* Tribunal had suggested an interpretation of Article 1105 different from that adopted by the FTC, it should be disregarded (*The Loewen Group, Inc and Raymond L. Loewen v. United States of America*, ICSID case no. ARB (AF)98/3), Final Award 23 June 2003, see *www.state.gov/documents/organization/22094.pdf*).

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ANNEX 5.A1

*Vienna Convention on the Law of Treaties**

Article 31. General Rule of Interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
   - any agreement relating to the treaty which was made by one or more parties in connexion with the conclusion of the treaty;
   - any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
   - any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
   - any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
   - any relevant rules of international law applicable in the relations between the parties;
4. A special meaning shall be given to a term if it is established that the parties so intended.

* Concluded in Vienna on 23 May, 1969. Came into force on 27 January, 1990. Ratified by 70 countries.

Article 32. Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to determine the meaning when the interpretation according to Article 31, or to determine the meaning when the interpretation according to Article 31:

a) leaves the meaning ambiguous or obscure; or

b) leads to a result which is manifestly absurd or unreasonable.

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Chapter 6

A Framework for Investment Policy Transparency*

Transparency remains one of the top concerns of investors worldwide. In October 2003, the OECD Committee on International Investment and Multinational Enterprises adopted a "Framework for Investment Policy Transparency" to assist host OECD and non-OECD governments to properly address to this concern. The Framework contains fifteen user-friendly questions for conducting self-evaluation and sharing experiences among public officials. The Framework completes the work on public sector transparency conducted in 2003 with the support of the 38 adherent countries to the OECD Declaration on International Investment and Multinational Enterprises.

* This article has been prepared by Marie-France Houde, Investment Division, OECD. It is based on a report initiated and approved by the Committee on International Investment and Multinational Enterprises in October 2003 (Public Sector Transparency and the International Investor (*www.oecd.org/daf/investment*).

1. Introduction

The following framework for investment policy transparency has been developed by the OECD Committee on International Investment and Multinational Enterprises to assist both OECD and non-OECD governments' efforts to enhance transparency of their investment policy frameworks and to serve as a basis for experience sharing among public officials. It completes the analytical work conducted in 2003 by the Committee on public sector transparency with the endorsement by the 38 adherent countries[1] to the OECD Declaration on International Investment and Multinational Enterprises.

Fifteen questions are proposed to government officials. These questions aim to facilitate self-evaluations and reporting of policy developments. They also can support peer reviews and multi-stakeholder dialogue on investment policy transparency. While the focus is on the information gaps and special needs of foreign investors, they apply, in most instances, to domestic investors as well. The questions are supportive of a level playing field for all investors.

The framework underlines the importance of effective communication of meaningful information, prior notification and consultation of regulatory changes and uniform administration and application of laws and regulations. It also pays particular attention to capacity-building issues and the evolution of international transparency commitments.

None of the questions in the framework are intended to be prescriptive however. The Committee recognises that transparency arrangements necessarily reflect national culture, history and values, and of course, availability of resources and skills. These must be adapted to local circumstances in order to be effective. At the same time, public authorities can learn from each other's regulatory experiences (such as how others have dealt with the emergence of new communication technologies).

Looking ahead, the Committee recommends that governments remain attentive to the evolving needs of investors and continue to search for novel and pragmatic solutions to new problems, as they are encountered. Transparency remains a moving target – it can be progressively upgraded and enhanced over time as regulatory environments evolve.

2. Framework for Investment Policy Transparency

2.1. Desirability and appropriateness of transparency for international investment

Question 1: Are the economic benefits of transparency for international investment adequately recognised by public authorities? How is this being achieved?

The Committee has recently stated that transparency is one of the most effective actions that public authorities may take to meet (domestic and) foreign investor's expectations.[2] In particular, it reduces business risks and uncertainties, helps combat bribery and corruption and ultimately promotes patient investment. Public authorities may not always be aware of these benefits or simply take them for granted. Conscious efforts are required to promote regulatory transparency.

2.2. How to make "relevant" information available to foreign investors

Question 2: What information pertaining to investment measures is made "readily available", or "available" upon request to foreign investors?

Ideally foreign investors should be able to obtain easily meaningful information on all the regulatory measures which may materially affect their investments. Investment measures may include laws, regulations, international agreements, administrative practices/rulings, judicial decisions and/or policies. Their sheer number and increased complexity and the potentially broad ramifications of business operations, however, may not always make this possible. It is nevertheless in governments' interests to provide "essential" information on how "to get a business started" and "operate it effectively". Recent trends in government practices,[3] international co-operative instruments,[4, 5] business circles,[6] and independent analysis[7] converge to suggest that foreign investors need to be informed, *inter alia*, about ownership and exchange control restrictions, administrative requirements, taxation, investment incentives, monopolies and concessions, access to local finance, intellectual property protection and competition policy as well as environmental and social requirements and corporate responsibilities.

Question 3: What are the legal requirements for making this information "public"? Do these requirements apply to primary and secondary legislation? Do they apply to both the national and sub-national levels? Is this information also made available to foreign investors in their countries of origin?

Legal requirements may derive from several sources (the constitution, laws and regulations, delegated regulatory powers…). They may also originate from public authorities at various levels of governments (central/federal, provincial, regional, municipalities). Moreover, it is not unusual nowadays for governments to take "pro-active" steps to inform foreign investors (including in their home countries) about prevailing investment conditions.

Question 4: Are exceptions/qualifications to making information available clearly defined and delimited?

The most common exceptions/qualifications to transparency are protection of confidential information or commercial interests, national security and public order, and pursuit of monetary and exchange rate policies. Special care should be given, however, to limit their application to the minimum extent possible and ensure that they are used within their legitimate purposes.

2.3. Publication avenues and tools

Question 5: What are the main vehicles of information on investment measures of interest to foreign investors? What may determine the choice of publication avenues? What efforts are made to simplify the dissemination of this information?

While culture and traditions and institutional capacity play a determinant role, there are various means of communicating regulatory information to foreign investors (official gazettes, communications by government departments or regulatory agencies, government websites, formal and informal contacts). Better public governance, new regulatory tools and technologies are contributing to a more effective and simpler communication on public policy between governments and stakeholders.

Question 6: Is this information centralised? Is it couched in layman's terms? In English or another language? What is the role of Internet in disseminating essential/ relevant information to foreign investors?

This may be done through national investment promotion agencies, special web sites online compendiums and e-gateways, special publications, etc. Even in this modern age, however, Internet is not an end in itself or automatic. It is a rapidly changing technology and environment, and for the information to remain "fresh", it must where feasible be collected and up-dated on a regular basis.

Question 7: Have special enquiry points been created? Can investment promotion agencies fulfil this role?

Because foreign investors may be in a disadvantageous position in comparison to national investors in understanding the domestic regulatory framework, they are bound to profit from special measures to make key information easily accessible and understandable to them.

Question 8: How much transparency is achieved via international agreements or by international organisations?

Transparency requirements under international agreements can provide a valuable source of information on domestic investment regulatory frameworks. Adhering governments may be called upon to notify regulatory changes, respond to special enquiries or requests for consultations, or subject themselves to peer reviews. International secretariats may also undertake their own studies on country policies.

2.4. Prior notification and consultation

Question 9: Are foreign investors normally notified and consulted in advance of the purpose and nature of regulatory changes of interest to them? What are the main avenues? Are these avenues available to all stakeholders?

Involving foreign investors and other stakeholders in the process of relevant regulatory changes can contribute to the legitimacy and effectiveness of the new regulatory investment measures. Allowing feedback through prior notification and consultation prior to actual decisions can help public authorities to devise better regulations and build support for compliance. Various notification and consultation avenues can be used. In addition to statutory notification or consultation requirements, governments may also take advantage of regular contacts with business associations or advice from business advisory bodies.

Question 10: Are the notice and comment procedures codified? Do they provide for timely opportunities for comment by foreign investors and accountability on how their comments are to be handled?

Better results are normally achieved when procedures are timely, transparent, open and accessible to all investors.

Question 11: Are exceptions to openness and accessibility to procedures clearly defined and delimited?

2.5. Procedural transparency

Question 12: What are the available means for informing and assisting foreign investors in obtaining the necessary licensing, permits, registration or other formalities? What recourse is made to silent and consent *clauses or* a posteriori *verification procedures?*

Registration, authorisation or permit formalities can impose large costs on business, both in time and money. These formalities may also be a source of administrative discretion, red tape and corruption. Every possible effort should thus be made to lighten the burden on business. It is important that they be administered in a transparent, uniform, impartial and reasonably speedy manner.

Question 13: What are foreign investors' legal rights in regard to administrative decisions?

Procedural transparency also implies a right to complain or appeal and the existence of prompt and impartial review and remedies. This may involve providing a clear description or other necessary explanation of the administrative requirements, statutory delays for rendering decisions and the possibility of presenting additional facts and arguments.

Question 14: To what extent "one-stop" shops may assist foreign investors fulfil administrative requirements?

Administration simplification and reduction programme, "one-stop" service shops and application of new technology may be additional means to enhance procedural transparency.

2.6. Capacity building

Question 15: What efforts are being made to address capacity building bottlenecks?

Setting transparency goals and drawing on other country experiences go hand in hand with improvements in administrative structures, staff training and investment in new technologies.

Notes

1. Thirty OECD members and 8 eight non-members: Argentina, Brazil, Chile, Estonia, Israel, Latvia, Lithuania and Slovenia.
2. "Assessing FDI Incentive Policies: a Checklist", *International Investment Perspectives*, OECD, 2003.
3. For example, the new French Government Agency for International Investment provides key information for doing business in France including setting up (formalities, legal structure, partnerships and commercial real estate), taxation employment and financial assistance (investment and job creation, innovation, training activities, incentives overview). See *www.afii.fr*, KISC, Korea's Investment Promotion Agency, as part of its services as a one-stop window, provides foreign investors with key information about Korean foreign investment regimes, including investment procedures, tax incentives, foreign investment zones, labour and industrial complexes for the exclusive use of foreign investors. Moreover, all procedures pertaining to the investment process from investment registration to factory establishment can be initiated through KISC. See *www.kotra.co.kr*.
4. Adherents to the OECD Declaration on International Investment and Multinational Enterprises are under the obligation to notify their exceptions to national treatment after establishment. These are classified under five main categories: investment by established foreign-controlled enterprises, official aids and subsidies, tax regulations, access to local bank credit and the capital market, government procurement. These measures may include general authorisation or licensing requirements, limitations or acquisition or expansion of activities, ceilings on foreign ownership, grants or financial assistance for specific activities, higher or special taxes, public works projects reserved to local firms, etc. Peer reviews conducted under the Declaration may also examine national foreign exchange regulations, the companies' law, employment and labour relations, intellectual property rights protection, competition law, money laundering, anti-

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corruption measures, international commitments, national security and public order measures, monopolies and concessions.

5. The World Bank Group is an important source of information about developing countries' legal and regulatory environments. Its Foreign Investment Advisory Service (FIAS) undertakes diagnostic studies to identify a country's main policy impediments to productive foreign direct investment. The issues typically identified include prohibitions on foreign investment in many sectors or locations; restrictions on the share of foreign ownership in the equity of domestic companies; difficult administrative approval processes; restrictions on repatriation of dividends and capital; taxes; the character and functioning of legal systems; and problems foreign firms have in gaining access to land and bringing in technical and managerial staff. *www.fias.net/services.html*. In the context of the preparation of the yearly World Investment Report, UNCTAD prepares, on an annual basis, an inventory of new regulatory changes relating to foreign direct investment with the assistance of member governments. The information sought, preferably in English, pertains to eight broad categories of measures: foreign ownership, sectoral restrictions, approval procedures, operational conditions, foreign exchange, promotion (including incentives), guarantees, and corporate regulations. Special themes (such as privatisation, intellectual property) may be examined in greater depth. Legal sources of the policy changes have also been compiled.

6. BIAC and the International Chamber of Commerce have recently underlined that all national provisions affecting rights of entry and post-investment operations such as sectors restricted to domestic investors, conditions applying to joint ventures, and taxation should be made publicly available. See ICC Policy Statement regarding a WTO investment agreement, Document 103/234 Rev. 7 Final EN, 7 March 2003.

7. In the area of foreign direct investment, the Heritage Foundation's Economic Freedom index focuses on foreign investment codes, restrictions on foreign ownership of business, restrictions on the industries and companies open to foreign investors, restrictions on performance to companies, foreign ownership of land, equal treatment under the law for both foreign and domestic companies, restrictions on repatriation of earnings, and availability of local finance. See *www.heritage.org/research/features/index/2002/*.

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Chapter 7

Promoting Corporate Responsibility: The OECD Guidelines for Multinational Enterprises*

The OECD Guidelines for Multinational Enterprises, a government-backed code of conduct for international business, has become an influential instrument for promoting appropriate standards of behaviour in today's global economy. The Guidelines contain voluntary recommendations in such areas as human rights, labour relations, environment, consumer protection, the fight against corruption and supply chain management. The Guidelines' distinctive follow up mechanism has been used to look at how these recommendations apply in concrete business situations ranging from resettlement of local populations in the Zambian copper belt to the risk of using child labour in outsourcing in India.

The Guidelines reinforce an ongoing trend in international business toward acquiring expertise in responsible corporate management. OECD research covering thousands of individual businesses and business associations shows that companies have invested heavily in their abilities to do this. In making these investments, they are often influenced by powerful incentives – e.g. the need to protect brand and reputation capital, legal and regulatory arrangements, pressures from labour and capital markets and the desire to forestall or shape more formal regulatory initiatives.

* The following text reproduces an article by the OECD Secretary-General Donald Johnston for a book on Corporate Social Responsibility to be published by the International Bar Association and Kluwer Law International.

1. Corporate responsibility and the international economy

International investment by multinational enterprises is at the heart of the current debate on globalisation. The Monterrey Conference and the Johannesburg Summit in 2002 called attention to the importance of responsible international business for spreading the benefits of globalisation more widely. The 2003 G8 Summit Declaration underscored the importance of "fostering growth and promoting a responsible market economy". The Declaration explicitly cites the OECD Guidelines for Multinational Enterprises and commits the G8 to work with interested countries to create an environment in which "business can act responsibly".

Thirty-eight governments – from the 30 OECD members and from 8 non-members[1] – have adhered to the OECD Guidelines for Multinational Enterprises, a government-backed code of conduct for international business. Today they are exploring how the Guidelines can best contribute to improving the functioning of the global economy and to promoting corporate responsibility. The Guidelines are recommendations by the 38 governments on business conduct covering such areas as human rights, labour relations, environment, combating corruption and consumer protection. Observance of these recommendations is voluntary for business, but the adhering governments make a binding commitment to promote them among multinational enterprises operating in or from their territories. In making this commitment, governments aim to "to strengthen the basis of mutual confidence between enterprises and the societies in which they operate, to help improve the foreign investment climate and to enhance the contribution to sustainable development made by multinational enterprises".[2]

The OECD's view is that the primary contribution of business – its core responsibility – is the conduct of business itself. The role of business in society is to develop investments so as to yield adequate returns to the suppliers of capital. In so doing, companies create jobs and produce goods and services that consumers want to buy.

However, corporate responsibility goes beyond this core function. Companies are expected to obey the various laws that are applicable to them and, as a practical matter, must often respond to societal expectations that are not written down in law books. Many multinational enterprises have tens of thousands of employees and hundreds of products. They straddle dozens of legal, regulatory and cultural environments. Because of this, compliance with

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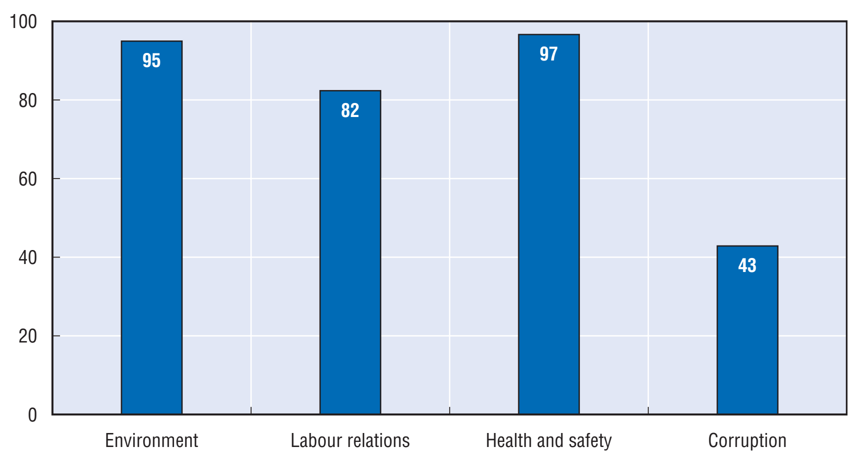
law and with societal expectations expressed through other, less formal channels is often a formidable challenge.

Many companies have invested heavily in trying to meet this challenge. Indeed, the development of business tools such as codes of conduct and related management and reporting systems has been one of the major trends in international business over the last 25 years. OECD research[3] shows that thousands of enterprises on at least four continents have participated in this trend. It also suggests that there are significant variations – by country and by sector of operation – in the issues companies choose to deal with and in their approaches to these issues. Examples of such divergences can be seen in Figures 7.1 and 7.2. Figure 7.1 shows that nearly all of the top 100 multinational enterprises publish policy statements on environment and health and safety while fewer than half deal publicly with the issue of corruption. Figure 7.2 reveals large sectoral variations in the propensity of companies to publish policy statements on corruption. While such variations reflect the diversity of companies' individual business environments, they also reflect other differences such as the state of development of agreed norms for conduct in different issue areas and sectors. Understanding these differences and encouraging convergence toward good practice are among the main objectives of the OECD Guidelines.

Of course, there is an ongoing debate about the effectiveness of voluntary initiatives. Some parties believe that they represent the business sector's contribution to the goal of building effective standards of international business conduct. This voluntary approach offers the flexibility needed to

Figure 7.1. **Policy statements by issue area**

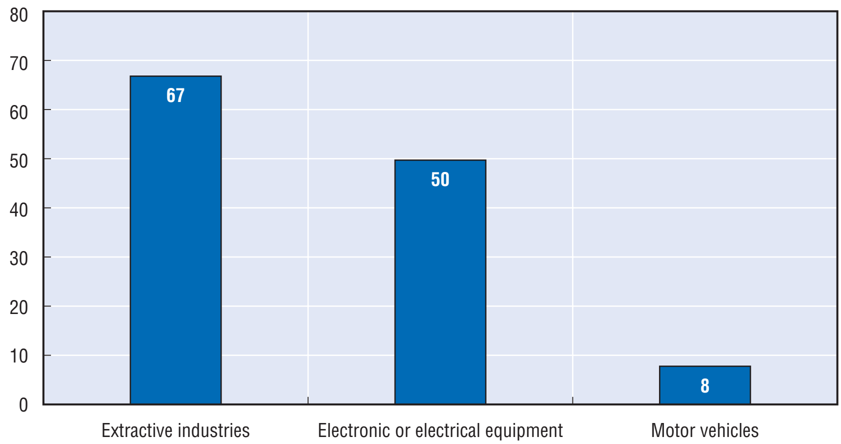
Number of companies in top-100 list making statements



Source: Annual Report on the OECD Guidelines for Multinational Enterprises: 2003 Edition.

Figure 7.2. **Anti-corruption statements by sector of activity**

Per cent of companies in sector sample



Source: Annual Report on the OECD Guidelines for Multinational Enterprises: 2003 Edition.

adapt to and learn from regional, sectoral and individual business circumstances. Others view these efforts as little more than public relations ploys and would favour replacing them with binding rules involving sanctions and other enforcement mechanisms. Only these, they feel, will give the standards enough "teeth" to influence corporate behaviour in a meaningful way. I will return to this point.

The OECD member governments believe that these initiatives are helping to improve the functioning of the global economy, as examples of their application have shown. Private initiatives allow businesses and societies to "feel their way forward" in the many areas where standards on acceptable management practices for business are not yet firmly established. For example, OECD research suggests that the published policies of OECD-based companies with outsourcing operations have tended to converge with respect to the core labour standards they ask their suppliers to observe. Nearly all companies with publicly-available outsourcing policies now mention all core labour standards, whereas few covered all core standards in the late 1990s.[4] However, the research also suggests that most companies – 118 out of a sample of 147 companies operating in sectors where core labour standards are a strategic concern – do not publish their outsourcing policies. Thus, while there is evidence of significant progress in this area, there is also evidence suggesting that many companies operating in sensitive sectors could do more to contribute to broader efforts to enhance compliance with core labour standards. The Guidelines provide several channels through which companies, trade unions and NGOs work with governments to promote further progress. As described below, these channels include:

1) discussions between adhering governments and other stakeholders of individual company conduct in specific business situations (including specific companies' approaches to respecting workers' rights to freedom of association or to managing the risk of employing child or forced labour); and 2) analysis and discussion of generic corporate responsibility issues.

At the same time, it would be naïve to think that a meaningful system of global norms could exist without binding regulation and formal deterrence. For the time being, much regulation and law enforcement is very much anchored in national economic systems. Future international regulation in some areas could emerge from gradual convergence and coordination of national practices. The OECD has taken steps to encourage this. The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions – which obliges signatories to enact laws and criminal sanctions against bribery of foreign public officials – is an important example. Another example can be found in OECD work on international tax enforcement. I would caution, however, against exaggerating the degree to which formal law enforcement can or should solve all the world's problems. I return to this idea in my conclusions. Moreover, many of these initiatives are not quite as "voluntary" as they might seem. Webster's dictionary defines "voluntary" as "acting or done with no external compulsion or persuasion". If one accepts this definition, then many private initiatives are not really voluntary – they are private responses (built into management systems and other business practices) that are driven by powerful financial, legal or regulatory pressures created by the broader society in which businesses operate. For example, environmental regulation in the European Union provides incentives for adopting certain environmental management practices. The US Federal Sentencing Guidelines provide another example of this deliberate coordination of public and private efforts. The Sentencing Guidelines provide powerful legal incentives (in the form of the possibility of more lenient sentences) for companies to adopt management systems that would allow them to show that they have made credible efforts to prevent violations of law by their employees.

Thus, the idea that there is a stark difference between binding and "soft" initiatives is not a valid one. In fact, these initiatives are integral parts of broader systems for influencing business conduct. The challenge is to promote a workable mix of public and private initiatives and to get all actors in the broader system – both public and private – to take up their responsibilities. Private initiatives by companies are part of this broader effort, but companies cannot, by themselves, create workable norms for conduct for the global economy. Indeed, the Guidelines recognise that business should not be asked to take on other actors' – especially governments' – responsibilities. If they are to build effective systems for promoting appropriate business conduct, governments and private sector actors must act in partnerships underpinned by an appropriate allocation of roles and responsibilities for each.

The OECD Guidelines for Multinational Enterprises, which I will describe below, are one of the most concrete examples in the OECD of how successful private-public partnerships can be used to help make the global economy work better.

2. The OECD Guidelines for Multinational Enterprises

The OECD Guidelines for Multinational Enterprises seek to encourage and reinforce the private initiatives for corporate responsibility that are described above. They express the shared views of 38 adhering governments on ethical business conduct.

Key features of the Guidelines are:[5]

- They contain voluntary recommendations to multinational enterprises in all major areas of business ethics.
- Adhering governments sign a binding commitment to promote them among multinational enterprises operating in or from their territories. Thus, the Guidelines represent a unique combination of voluntary and binding elements.
- The most visible sign of adhering governments' commitment to the Guidelines is their participation in the instrument's distinctive follow-up mechanisms. These include the operations of National Contact Points (NCP), which are government offices charged with promoting the Guidelines and handling enquiries in the national context.
- One of the NCPs' responsibilities is to consider "specific instances". Under this procedure, NCPs act as referees in multi-stakeholder discussions of specific company behaviour in specific business situations. In effect, this creates a case based approach to the problem of building behavioural norms for appropriate international business conduct.
- The Guidelines are part of a broader and balanced instrument of rights and commitments – the OECD Declaration on International Investment and Multinational Enterprises. In addition to the Guidelines, the Declaration provides guidance for governments in the areas of national treatment, avoiding imposing conflicting requirements on international investors and investment incentives and disincentives.[6]

The 38 governments that adhere to the Guidelines represent countries that are the source of most of the world's foreign direct investment and are home to most major multinational enterprises (97 out of UNCTAD's top 100 multinational enterprises are covered by the Guidelines). Although the Guidelines have been in existence since 1976, they were significantly revised in June 2000. After four years of implementation under the revised procedures, it is fair to ask what kind of impact the Guidelines have had to date.

3. Results to date

The 2000 review of the Guidelines and subsequent work by adhering governments have strengthened the instrument and raised its profile. There is growing evidence that the Guidelines are becoming an important international tool for corporate responsibility. The Guidelines have been translated into at least 24 languages. A recent survey asked managers of international companies to list influential international benchmarks for corporate behaviour – 22 per cent of them mentioned the Guidelines without prompting. Some 60 000 Web pages refer to the Guidelines. Fifteen countries use the Guidelines in their export credit and investment guarantee programmes. In addition to the formal adherence by 38 governments, the Guidelines have received official support from business and trade union representatives at the OECD. NGOs have formed a coalition to make use of them.

The implementation procedures are being actively used, tested and refined. As of June 2003, 64 specific instances had been considered.[7] Some of these deal with company conduct in OECD countries, but most look at business conduct in non-OECD countries and cover issues that go to the heart of the current debate on globalization. For example:

- *Zambian copper mining.* The Canadian NCP has looked into the resettlement plans of a company operating in Zambia's copper belt. As a result of this consideration, the company agreed to postpone its resettlement plans for one year to allow time to rethink the plans – both the company and the NGO coalition (involving a Canadian and Zambian NGO) that were parties to this specific instance agreed that the procedure made a useful contribution to reducing tensions.
- *Korean suppliers in a Guatemalan export processing zone.* The Korean NCP has looked into a Korean company's respect of freedom of association – a core labour standard – in an export processing zone in Guatemala. The Korean NCP encouraged the company to inform the Guatemalan workers of their rights and to respect these rights. The company responded by issuing a manual in comic book form illustrating workers' rights under Guatemalan law.
- *Swedish business service provision in Ghana's gold sector.* The Swedish NCP looked at two Swedish companies' involvement (as business service providers) in Ghana's gold sector. The NCP collected information from on-site visits, from the Swedish embassy and from Ghanaian NGOs. It concluded that, while there are significant environmental and social problems in Ghana's gold sector, the two companies could not be held responsible for these problems because they were too far removed from them.

These are just a few of the many specific instances that have been considered by NCPs so far. Some of the positive developments that have been noted from these and other experiences include:

- *Using the embassy networks as an accountability mechanism.* It is now becoming common practice for NCPs to use embassies (as well as employees from overseas development assistance programmes) as sources of information for consideration of "specific instances" (*e.g.* see Swedish case above). In 2003, five adhering countries now feature the Guidelines as part of the training material given to embassy personnel before they take up their posts.
- *Giving a voice to trade unions and civil society actors from the non-OECD area.* Many of the specific instances have been brought by trade unions and NGOs from the non-OECD area working in partnership with OECD-based actors. The Guidelines strengthen these non-OECD actors by providing an international forum in which they can voice their concerns and by allowing them to gain experience with international institutions and procedures.
- *A way for governments to engage with companies on issues of business ethics at a lower standard of "proof" than that required by formal legal proceedings.* A number of actors, including the UN Expert Panel on the illegal exploitation of natural resources in the Democratic Republic of Congo, have noted that the Guidelines allow governments to engage with companies with greater flexibility than that permitted by legal proceedings.
- *A tool for companies.* Trade unions and NGOs have been attracted to the specific instances procedure for some time. But companies are now starting to realize that it can be a useful tool for them as well. Business recently asked the Guidelines institutions to assist them in dealing with bribe solicitation and ways of responding to this request are currently being explored. In addition, the specific instances procedures can help provide concrete guidance to companies – it can reassure them (as in the Swedish case described above) while sometimes also helping them to identify shortcomings.

Guidelines implementation – which includes an annual Corporate Responsibility Roundtable organized in conjunction with the annual meeting of NCPs – also provides an opportunity for business, trade unions and NGOs to share their views on major corporate responsibility issues (*e.g.* responsible supply chain management, business' contribution to the fight against corruption). Among other things, this allows them to influence NCPs thinking on high profile issues. The summaries of these discussions, published in the annual reports on the Guidelines, provide a public record of the views of governments, business, trade unions and NGOs on these issues.

4. Ongoing challenges

While their overall visibility has grown, more needs to be done to raise public awareness of the Guidelines and to demonstrate that they can make a vital contribution to the global economy. A number of priority areas for future work have been identified:

- ***Transparency and effectiveness of NCPs.*** The NCPs are focusing on enhancing the transparency and effectiveness of their operations. They are sharing their experiences through a regular annual meeting in order to ensure that the specific instances are considered in a fair way. One of the main outstanding issues is the disclosure of information at the various stages of the "specific instances" process.
- ***Parallel legal procedures.*** Surveys of NCPs show that specific instances are often conducted in parallel with consideration of related matters under legal or administrative procedures. NCPs have started to explore under what circumstances the Guidelines procedures can make positive contributions over and above those made by other procedures.
- ***Enhancing the contribution of business in weak governance zones.*** The OECD is working on providing terms of reference for conducting business with integrity in countries with very weak governance. This work will draw on the OECD's integrity package, which includes the Guidelines as well as the OECD Anti-Bribery Convention and Recommendations, the Corporate Governance Principles and Guidelines on Avoiding Conflict of Interest in the Public Service.
- ***Partnerships with other international organizations.*** The Guidelines are one of several global corporate responsibility initiatives. The OECD is building partnerships with other international organisations – in particular with the United Nations, the World Bank and the Global Reporting Initiative (GRI). The GRI has issued a map of how the GRI indicators can be used by companies to report on their performance relative to the Guidelines' recommendations. The OECD Investment Committee will be working with the UN Global Compact on follow-up to the UN Expert Panel's Report on Illegal Exploitation of the Democratic Republic of Congo.

5. Conclusions

Having been a practicing lawyer and a parliamentarian, my bias has been towards controlling much behaviour through laws and regulations – a rules-based system, if you like. My view has changed. The OECD Guidelines for Multinational Enterprises (like the OECD Principles of Corporate Governance) set out a number of "principles" for international behaviour which underpin good corporate citizenship, no matter what may be the local legal framework. Effective pressure for good corporate behaviour can be exercised not only by legal tribunals with lawyers debating whether a rule has been breached, but also by the court of public opinion, often finding its expression at shareholders meetings and in consumer action. The Guidelines are a code of conduct attached to a government-backed mediation procedure that reinforces these market pressures. This procedure has been used many times and in a variety of ways, ranging from "naming and shaming" to highlighting the positive steps taken by companies. It also provides a mechanism through which governments help businesses explore what ethical conduct means in situations where this is far from obvious. Thus, the Guidelines promote appropriate international business conduct by raising the incentives for acting responsibly and by helping companies understand what appropriate conduct is.

Notes

1. The eight countries are Argentina, Brazil, Chile, Estonia, Israel, Latvia, Lithuania and Slovenia.
2. Preface of the OECD Guidelines for Multinational Enterprises.
3. *Corporate Responsibility: Private Initiatives and Public Goals*, OECD, Paris, 2001.
4. The core labour standards are set forth in the International Labour Organisation's *Declaration on Fundamental Principles and Rights at Work*. They include freedom of association, elimination of all forms of forced or compulsory labour, effective abolition of child labour, the elimination of discrimination with respect of employment and occupation. For a detailed discussion of these standards, see *International Trade and Core Labour Standards*, OECD, Paris, 2000.
5. For fuller information on the Guidelines, see *www.oecd.org/daf/investment/guidelines/*.
6. For fuller information on the OECD Declaration, see *www.oecd.org/daf/investment/instruments/*.
7. *2003 Annual Report on the OECD Guidelines for Multinational Enterprises: Focus on Enhancing the Role of Business in the Fight Against Corruption*, OECD, Paris, 2003.

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