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**Negotiating Group on the Multilateral Agreement on Investment (MAI)**

**Expert Group No.3 on “Special Topics”**

**INVESTMENT INCENTIVES**

**(Note by the Chairman)**

## INVESTMENT INCENTIVES

(Note by the Chairman)

### I. Introduction

1. The present Note explores the scope of MAI obligations in the area of investment incentives (IIs) drawing on the outcome of the orientation debate in the Negotiating Group in January 1996, which was carried out on the basis of a note by the Chairman [DAFFE/MAI(96)5] and a contribution by one delegation [DAFFE/MAI/RD(96)5].

2. The Negotiating Group has concluded that as a high standard agreement, the MAI would need to cover IIs. These measures can have distorting effects on cross border investment flows and lead to costly competitive bidding among governments to attract foreign investment. This is, however, a politically sensitive and technically difficult subject. There may be difficulties in developing special provisions in this area. The MAI may try, as a first step, to consolidate the disciplines found in existing international agreements and reinforce them to the extent possible.

3. The first part of the Note therefore explores how the proposed core obligations of the MAI (namely national treatment and most favoured nation treatment and transparency)<sup>1</sup> could apply to investment IIs. The last part of the Note discusses the feasibility of developing obligations over and above these disciplines. No drafting proposals are made at this stage.

4. As with other documents submitted for consideration by the Expert Group, the avenues being explored are without prejudice to the treatment of other issues in the negotiations, including taxation<sup>2</sup>. The subject of Performance Requirements (PRs) is addressed in document DAF/MAI/EG3(96)2.

### II. Definition Issues

5. There is a wide range of motivations for IIs. IIs are commonly used by governments to promote economic growth and employment by stimulating investment and the upgrading of skills. They may be a tool for the development of economically disadvantaged regions or segments of society and industrial and structural adjustment policy. They may involve several levels of government, including local authorities and municipalities.

6. IIs may also take various forms. They may be provided to firms through grants and subsidies. They may involve tax advantages or tax reductions, the availability of infrastructure facilities or R&D

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<sup>1</sup> As defined by Drafting Group N°2 in DAF/MAI/DG2(96)2.

<sup>2</sup> See Elements of a Draft Report on the Treatment of Tax Measures in the MAI[DAFFE/MAI/EG2(96)4] and Summary Record of the Meeting held on 22-24 April 1996[DAFFE/MAI/EG2/M(96)1].

capability. They may be associated with the allocation of government contracts, government concessions or other regulatory advantages.

7. Clearly every form of IIs can be used to attract foreign investment. The motivation may generally be the same as that for domestic investment, i.e. to foster economic activity and employment. In this case, there would be no *a priori* reasons for treating foreign investors differently than local investors.

8. But IIs may also be specially designed to attract investment funds from abroad because of perceived advantages that domestic firms do not have, for instance, in matters of R&D capability, know-how and training, or to enlarge the domestic pool of capital and know-how available locally. This may lead to "positive" discrimination in favour of foreign firms. This category of IIs may run the higher risk of distorting investment flows and engaging governments in costly competitive bidding for these investments.

9. The elaboration of disciplines on IIs not exclusively designed to attract foreign investment may not necessarily require establishing a full inventory of such measures, particularly if the obligations were to be confined to National Treatment and Most Favoured Nation treatment obligations. In fact, the National Treatment instrument does not define IIs even if they are clearly covered by it<sup>3</sup>.

10. If additional disciplines were to be contemplated, however, for IIs responsible for major distortions in international investment flows and costly competitive bidding between governments, it would probably be necessary to define the IIs concerned beforehand. The feasibility of developing additional provisions is discussed in section V below.

### **III. National Treatment and Most Favoured Nation Treatment**

11. The Drafting Group N°2 [DAFFE/MAI/DG2(96)2] has defined National Treatment and Most Favoured Nation Treatment as follows:

*"Each Contracting Party shall accord to investors of another Contracting Party and to their investments, treatment no less favourable than the treatment it accords [in like circumstances] to its own investors and to their investments with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of investments.*

*Each Contracting Party shall accord to investors of another Contracting Party and to their investments, treatment no less favourable than the treatment it accords to [in like circumstances] to investors of any other Contracting Party or of a non-Contracting Party, and to the investments of investors of any other Contracting Party or of a non-Contracting Party, with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of investments.*

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<sup>3</sup> The National Treatment Instrument defines categories of measures which may constitute exceptions to National Treatment. These categories include financial (grants, low-interest loans, interest subsidies and state guarantees and non-financial aids to enterprises provided by the state as a supplier of funds; aids and subsidies granted as a shareholder of an enterprise or to offset a particular requirement imposed on an enterprise, tax incentives and government purchasing from locally-established enterprises. The treatment of tax measures is governed by a number of understandings. See the clarifications of exceptions by category of measures outlined in National Treatment for Foreign-Controlled Enterprises, OECD, 1993, pages 28-36.

*Each Contracting Party shall accord to investors of another Contracting Party and to their investments the better of the treatment required by paragraphs 1 and 2, whichever is the more favourable to those investors or investments."*

12. While some delegations would have preferred separate articles on pre- and post-establishment, the majority of Delegations felt that a single text would better capture the intended coverage of the agreement and avoid the difficult task of defining the boundary between pre- and post-establishment. It was agreed, as a starting point, to work on the basis of a single text. In the absence of a provision stating otherwise<sup>4</sup>, IIs would automatically be covered by these obligations because they would be part of the "treatment" accorded to foreign investors and their investments. This would represent a substantial broadening of existing obligations under the OECD instrument since the National Treatment applies only to IIs provided to already foreign-controlled enterprises.

13. It is therefore for consideration whether there is a need to qualify the scope of application of the National Treatment and Most Favoured Nation Treatment obligations in the area of IIs, being it understood that Contracting Parties would have the possibility to lodge reservations for non-conforming measures.

#### **Questions:**

- Does the Group agree that National Treatment and Most Favoured Nation obligations would apply to IIs provided at both the pre- and post-establishment phases ?**
- If not, which IIs might be excluded from the pre- or post-establishment phase obligations and what would be the reasons for the exclusions ?**
- When National Treatment is not provided, should Most Favoured Nation apply in all cases as a matter of principle ? If there to be exemptions, how would they be justified?**

#### **IV. Transparency**

14. For investment incentives to serve their purpose, it is important that investors are made aware of their existence. There may be various techniques to make this information available, but public dissemination would appear to be one of the best ways. It offers the best guarantee that interested investors would be able to bid for and obtain available IIs. Because of the great diversity of IIs, however, it may not always be possible for public authorities to publicise every relevant piece of information. Investors also have some responsibility in finding out what IIs there are in the host countries they operate.

15. As they presently stand, the transparency obligations of the MAI [DAFFE/MAI/DG2(96)2] would require each Contracting Party "to promptly publish, or otherwise make publicly available, its laws, regulations, procedures<sup>5</sup>" on IIs in so far as they "may affect the operation of the Agreement". Each

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<sup>4</sup> The application of National Treatment and Most Favoured Nation Treatment to tax measures in under discussion in the Expert Group No. 2.

<sup>5</sup> ... and administrative rulings and judicial decisions of general application as well as international agreements which may affect the operation of the Agreement. [Where a Contracting Party establishes policies which are not expressed in laws or regulations or by other means listed in this paragraph, but which may affect the operation of the Agreement, that Contracting Party shall promptly publish them or otherwise make them publicly available.]

Contracting Party would also be obliged to promptly respond to specific questions and provide, upon request, information to other Contracting Parties on matters raised by the IIs<sup>6</sup>.

16. The scope of application of these provisions to IIs would depend on the coverage of IIs under the Agreement since only those IIs could affect its "operation". A broad application of National Treatment and Most Favoured Nation Treatment would go a long way because relevant IIs would need to be published or otherwise made publicly available". Transparency would also result from country specific reservations describing non-conforming measures to these obligations.

17. The transparency provisions defined by the Drafting Group N°2 would not capture, however, all economically distorting IIs. To create a transparency obligation in this field would require a precise identification of the IIs concerned. This matter is discussed in Section V.

18. There might also be merits to consider a "best endeavour" undertaking for Contracting Parties to publish every IIs they have. The OECD Instrument on Investment Incentives and Disincentives requires, in fact, every Member country to "endeavour to make such measures as transparent as possible so that their importance and purpose can be ascertained and that information can be readily available<sup>7</sup>. A similar provision could be included in the MAI either as a separate article or in the Transparency Article. Enquiry points could be established as a means of providing information on IIs<sup>8</sup>.

#### **Questions:**

**-- Are the transparency provisions proposed by the Drafting Group N°2 sufficiently broad to cover all IIs of concern? If not, please elaborate how they could be improved and modified?**

#### **V. Additional provisions**

19. Going beyond the disciplines of National Treatment and Most Favoured Nation Treatment obligations and those discussed for PRs would require specific provisions in the MAI.

##### ***i) Prohibition of "positive" discrimination***

20. The National Treatment obligation would not prevent Contracting Parties to offer "more" favourable IIs to foreign investors than to national investors. In a federal country, a province or a state's II programmes might even favour foreign investors over investors from other states or provinces.

21. The MAI could provide, however, in a separate article, that domestic and foreign investors should receive the "same" or an "equivalent" treatment in the allocation of IIs. While governments may lose flexibility in their quest for new investments, IIs programmes may gain in fairness and acceptability, both at home and abroad. There is also a built-in budgetary discipline in requiring equal treatment since a larger amount of funds would be needed to provide the same IIs to national and foreign investors. Competitive bidding for international investment would become more costly and less effective.

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<sup>6</sup> Contracting Parties would not be required to disclose confidential business information, however.

<sup>7</sup> No definition of IIs is provided but the possible coverage of provisions can be far reaching.

<sup>8</sup> This idea has been floated in the Drafting Group N° 2, see DAF/MAI/DG2(96)2, page 7.

22. There might be both political and practical difficulties in applying this obligation, however.

**Questions:**

-- **Should the MAI attempt to prohibit "positive" discrimination in the allocation of IIs? Could such an obligation be contemplated generally or with regard to certain types of IIs? Please elaborate.**

*ii) Specific limitations on the use of IIs*

23. While the Negotiating Group recognised that ceilings or prohibitions on the use of certain IIs would probably be the most effective way of reducing, if not eliminating, economic distortions and competition in the field of IIs, it also anticipated serious difficulties with the elaboration of obligations in this area. Given the prevailing imperfect knowledge about existing national IIs programmes, it would, in any case, be necessary to establish an inventory of IIs in the most transparent manner possible.

24. Ideally, this inventory would determine what incentives are offered, by whom, in what form and in what magnitude. A taxonomy may also need to be developed to categorise IIs by objective (e.g. to encourage location or expansion of productive capacity, to encourage R&D, to encourage worker training) and by form (e.g. cash subsidy, tax break, provision of land or infrastructure). It might also be appropriate to rank IIs by degree of "objectionability".

25. This would provide the basis for defining limitations on IIs, starting with the most damaging ones. These limitations might be set in proportion to the size of the project assisted or in terms of absolute amounts. Export subsidies should be prohibited altogether to ensure consistency with the WTO Agreement on Subsidies and Countervailing Measures.

26. An alternative approach might be to establish "guidelines" for the use of certain IIs, drawing on the procedures of the OECD Arrangement on Guidelines for Officially Supported Credits, which sets upper limits for offering this type of official support. This "best endeavour" instrument operates through close scrutiny and review of the export credits conditions offered by Member countries.

**Questions:**

- **Could experts comment on these various ways of limiting the use of IIs and indicate to what extent such options can be pursued in current timetable for the negotiations? Should aspects be considered for future work in the context the implementation of the MAI ?**

*iii) Consultations*

27. Consultations procedures are likely to play a major role in the implementation of the MAI. They could be an built-in feature of the transparency provisions of the Agreement. They could be the first procedural step for a MAI dispute settlement mechanism [DAFFE/MAI/EG1(96)5]. They could also be part of other functions of the "Parties Group" which need still to be defined. These procedures would normally apply if IIs were to be covered by the National Treatment and Most Favoured Nation Treatment obligations.

28. It is for consideration whether specific procedures are needed for IIs which might not be subject to these procedures. There are a few precedents in existing international agreements.

29. The Subsidies Agreement of the WTO allows for consultations even in the case of "non-actionable" subsidies. When a non-actionable subsidy results in "serious adverse effects to the domestic industry" of an importing country, "such as to cause damage which is difficult to repair", bilateral consultations can be sought to find a solution. If a solution cannot be found, the matter may be referred to the Committee on Subsidies which may recommend the modification of the subsidy to remove its "serious adverse effects on the importing country.

30. Under the OECD Instrument on International Incentives and Disincentives, Member countries are encouraged to recognise the need "to give due weight to the interests of other Member countries in providing official incentives or disincentives to international direct investment". They must be prepared to engage in bilateral consultations should this be the wish of another Member. A Member country may also bring any matter of concern to the Organisation, which may recommendations to solve the problems identified.

**Questions:**

- **Should the MAI contain special consultation procedures for "non-actionable" IIs? In the affirmative, which avenues deserve further consideration ?**