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THE 'FLEXIBILITY MYTH': Why GATS Is A Bad Model For A New WTO Investment Agreement

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Introduction

In an attempt to quell discontent over its proposal to negotiate new rules on investment in the World Trade Organisation (WTO), the European Union (EU) – the principle proponent of new rules – has emphasised the potential for 'flexibility' in any new agreement. In particular, the EU has proposed to follow a similar approach to that of the existing WTO rules covering investment in services – the General Agreement on Trade in Services (GATS). For example, the EU has stated, *"The question of admission should be addressed following a GATS-type approach based on positive commitments. We believe that this approach would allow enough flexibility for all WTO members."* [1] Before signing up to such a proposal, it is therefore critical for governments to examine whether the GATS really has delivered the kind of 'flexibility' that enables countries to achieve development.

Based on the mounting evidence on how successful countries have used 'discriminatory' investment policies to develop, and on the lack of evidence that binding rules help poor countries attract more investment, WDM takes a highly skeptical view on the purported 'benefits' of proposed WTO investment rules. WDM believes 'non-discrimination' is not an appropriate rule to apply to investment, and on these grounds alone opposes insertion of new investment rules in the WTO. However, it is not WDM's intention here to argue over the details of investment liberalisation case studies. It is our intention to deal specifically with the myth that GATS is a 'flexible' agreement and thus a 'GATS-style approach' can be used to ensure any new agreement on investment will allow developing countries to pursue appropriate development policies.

GATS Flexibility? Not if we don't know what the rules mean

The first problem with the 'GATS is flexible' argument, is that it is hard to be flexible when we don't know what the rules mean. The GATS is riddled with uncertainty, which undermines effective government policy-making.

For example, there is uncertainty over what measures are covered by the 'de-facto discrimination' rules of Article XVII; uncertainty over exactly what constitutes 'government procurement' of services and thus is (currently) not covered by GATS rules; uncertainty over whether the rules on 'domestic regulation' will apply across the board or only to specific commitments and therefore whether and how governments can list limitations to these rules; uncertainty as to what kind of regulations would violate a 'necessity test' requiring measures to be 'no more burdensome than necessary'; and uncertainty over how GATS applies to subsidies.

There even seems to be some confusion over the exact coverage of the standard market access and national treatment rules. For example, if GATS rules so clearly exempt all public interest regulations — as claimed by the European Union — why did four European countries feel the need to specifically list a limitation to their commitments in the 'hotels and restaurants' sub-sector allowing them to *"protect areas of specific historic and artistic interest"*?[2] What does this mean for the other 108 WTO members who have made commitments in this sub sector but may not have listed such a limitation?

As the former WTO Director General, Renato Ruggiero stated at a conference in 1998, the GATS extends into *"areas never before recognised as trade policy"*

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and that *"neither governments nor industries have yet appreciated the full scope of these guarantees or the full value of existing commitments."* [3] So how can GATS be flexible if governments do not know what its rules mean?

If similar rules on domestic regulation, market access, *de facto* discrimination and subsidies are transposed into a new investment agreement – and there is every reason to think they will be – the uncertainty will simply be transferred to more parts of the economy. The 'flexibility' of countries to regulate in the manufacturing, mining, agriculture and fisheries sectors will be undermined by not knowing what exactly is WTO legal, and effective development policy will be left hanging on the interpretation of future WTO Panels.

GATS Flexibility? Yes, but only if you are blessed with magic powers

The second problem with the 'GATS is flexible' argument is that GATS requires governments to be able to see into the future.

It is true that the GATS allows governments to list what are called 'limitations' or exceptions both across all sectors and to their specific commitments. For example, in the banking sector, India has reserved its right to place a ceiling of 15 per cent for assets of foreign banks in the total assets of the banking system. And in the tourism sector, Jordan has reserved its right to be able to require foreign travel agents to implement their tours through local service providers.

This all sounds fine. But the problem is that countries are supposed to come up with a list of all the possible GATS incompatible regulations that they might want to use in the future at the time they make the commitment. This is no small feat given the existing, and uncertain, coverage of rules on market access, national treatment, *de facto* discrimination and the potential coverage of new rules on domestic regulation. Also, how can any government official know in advance what potentially GATS incompatible regulations *future* governments might want to use?

This problem is exacerbated by the lack of assessment (as mandated by Article XIX), both on the impacts of liberalisation and on the impacts of GATS rules on the ability of national and local governments to effectively regulate. And developing countries are at a particular disadvantage when it comes to undertaking this kind of research and analysis.

Regardless of a government's administrative capability, this restriction denies the opportunity for an iterative process when it comes to regulation. No government gets it right first time all the time. Yet in the fantasy world of the GATS, government officials are seemingly blessed with omniscience.

The opportunity to list limitations to specific commitments is likely to be advertised as one of the 'selling points' for a new investment agreement, but the GATS experience demonstrates that, in reality, the 'flexibility' it provides is illusory.

GATS Flexibility? Not for future governments

A third problem with the mythical GATS flexibility is that policies become 'locked-in'.

The GATS does have a procedure (Article XXI) for governments to withdraw commitments but this can only be initiated three years after the commitment is made and requires compensation, normally in the form of some other kind of liberalisation, which then requires the consent of other WTO members that may be affected. This makes it extremely difficult, and perhaps impossible, for governments to withdraw commitments. The former Director of the WTO Services Division, David Hartridge, noted that these provisions make GATS commitments *"effectively irreversible"*. [4]

Therefore, once a country makes a GATS commitment, there is effectively no turning back. This has massive implications for democracy and the right of future governments to change the direction of economic and social policy.

On this issue of 'lock-in', it is worth bearing in mind a case from Thailand. In a submission to the WTO last year, Thailand describes how it liberalised its retail sector, attracting investment from European retail chains. This has had both benefits and drawbacks. Over time, the Thai Government has realised that it needs to intervene in the market to address the adverse impacts on its domestic retailers.[5] Critically, it has not made any GATS commitments in retail so it is relatively free to develop whatever mechanisms are appropriate.

The lessons from this case are twofold. First, it is clearly possible to attract investment without making GATS commitments. Second, all governments make mistakes and it is much easier to go through an iterative regulatory process if you have not made GATS commitments. Unfortunately, the EU has targeted the Thai retail sector in the current negotiations and the Thai Government seems to be having second thoughts about implementing strong regulations.

Real flexibility allows governments to learn from experience and allows future governments to change policies. The GATS denies this, and there is every reason to think that a similarly strict 'withdrawal process' will be included in any new investment agreement. This will, over time, ensure that developing countries are unable to re-regulate investment in response to changing circumstances, changing governments or evidence that a particular policy is failing.

GATS Flexibility? How flexible is a train that can't stop?

The fourth problem to highlight is that GATS has no end point.

The GATS enshrines a commitment to keep on liberalising. Article XIX includes a commitment to *"successive rounds of negotiations, beginning not later than five years from the date of entry into force of the WTO Agreement and periodically thereafter, with a view to achieving a progressively higher level of liberalization."*

This exerts a long-term deregulatory pressure on governments. In particular, the regulatory 'exemptions' that governments list in one round of negotiations are targeted for removal in the next round. It is clear that just such a 'tit-for-tat' bargaining process is going on in the current negotiations. A recent leak of the EU's requests of 109 countries clearly demonstrates it is targeting removal of the regulatory conditions developing countries listed in the last round of talks (see Appendix). Some of these regulations — for example, Cameroon's ability to require investors to create jobs — are wide ranging and potentially affect more than just the service sector. The whole process of GATS negotiations is therefore, over time, aimed at continually reducing what little flexibility governments started out with. This begs the question, where will it end? The development process takes many decades, or even centuries, yet in just a fraction of this time the GATS 'flexibility' to list and maintain limitations is being eroded as development policies are targeted for elimination in successive rounds of talks.

Again, there is every reason to believe such a 'progressive liberalisation' clause will be included in any new investment agreement. This will ensure that, regardless of their economic progress, developing countries will come under pressure in a relatively short timespan (e.g., 10 - 20 years) to eliminate a whole raft of development policies.

GATS Flexibility? Yes, but for the economically powerful

The final problem is that the flexibility that governments can exercise in the GATS, and their ability to choose exactly when and how to liberalise, is dependent on a fair process conducted amongst equals. This is not currently the case in the WTO — developing countries are put under significant pressure by economically and politically powerful WTO members such as the EU.

In theory, the WTO is a place where developing countries can group together to increase their bargaining power but the bilateral request-offer process in GATS makes such strength in numbers difficult, if not impossible. This problem is exacerbated by the lack of capacity in poor countries to adequately deal with the huge scope of GATS. It has been reported that single developing country negotiators — who are often responsible for covering a wide range of different, and extremely complex WTO agreements — are going into bilateral GATS negotiations against twelve or so industrialised country experts, each specialising in just one part of one WTO agreement.[6]

According to the Ambassador of Bangladesh to the WTO, *"When you go into a bilateral format of the negotiations, you are vulnerable. Why? Because against a major developed country, you simply cannot withstand the level of scrutiny. And you do not have the strength in the numbers that you get in the multilateral process. This is exactly what happens bilaterally in the WTO. Within a multilateral context, in the WTO, sometimes developed countries are unable to get their way with us. But when you come to the bilateral mode, we find that where they are unable to persuade us to agree to something multilaterally, they apply pressure bilaterally to get it done."*[7]

It is therefore asking people to be very politically naïve if they are expected to believe that bilateral GATS negotiations are simply a friendly one-to-one chat between a rich and a poor country official discussing the relative human development merits of different possible GATS commitments. Pressure is part and parcel of the process and a country's GATS 'flexibility' is therefore, to some extent, relative to its political and economic clout.

This pressure is further exacerbated by the way the 'single undertaking' allows links to be made across negotiating issues. Members such as the EU can, for example, trade off modest changes to the Common Agricultural Policy (CAP) in return for binding GATS commitments, or new rules on investment, from developing countries. However, as one Harvard economist concludes, *"The exchange of reduced policy autonomy in the South for improved market access in the North is a bad bargain where development is concerned."*[8]

The 'GATS-style' bilateral process – and all the potential for pressure it creates – is proposed for a new investment agreement. This completely undermines one of the standard arguments used in favour of new WTO investment rules – that developing countries can club together in the WTO and this is preferable to going into a bilateral investment treaty negotiation with an industrialised country. The GATS request-offer process is a whole series of bilateral investment negotiations but where the GATS differs from a bilateral treaty negotiation is that any commitments made are multilateral (i.e., apply to all countries) so are more far reaching. Transferring this system to a new investment agreement will simply provide another forum in which regular bilateral pressure can be exerted on developing countries to get rid of investment regulations.

Conclusions

In summary, the much-hyped 'flexibility' of the GATS is a myth. It is in fact undermining the ability of developing countries to use appropriate policies to achieve development. In particular, the arguments over the 'flexibility' of the GATS are massively flawed because:

- Its rules (e.g., on *de facto* discrimination, domestic regulation and subsidies) are riddled with uncertainty, encouraging a lowest common denominator approach by regulators.
- It has a ridiculous requirement that governments should be omniscient and know, in advance, all the possible GATS incompatible regulations they, or successive governments, might want to use in future in order to list exemptions at the time of making commitments.
- It effectively 'locks-in' policy, making it extremely difficult, if not impossible, to alter commitments. This denies future governments the option to change economic course, roll-back liberalisation, increase regulation or list extra exemptions.
- It has no end-point.
- It is an extremely complex agreement involving bilateral negotiations and multilateral commitments, providing opportunities for political and economic pressure to be exerted on developing countries.

Experience with the GATS clearly shows that a 'GATS-style positive list approach' does not guarantee the flexibility developing countries need to pursue appropriate policies. In fact, over time, the GATS guarantees a steady *reduction* in flexibility. WDM therefore believes transposing this system to a new investment agreement would be a mistake and urges governments to abandon plans for new WTO rules on investment (covering the mining, manufacturing, agriculture and fisheries sectors), whether through a GATS-style approach or not.

Appendix: Regulations Targeted by the EU for Elimination Through GATS

'Across the board' regulations targeted by the EU in the current GATS talks

Across-the-board restrictions, which limit the activity of foreign investors in all service sectors, are clear EU targets. Although a country may not necessarily be implementing these policies, by acceding to EU demands to remove these restrictions from its GATS listing, it is giving up its right to use these policies in the future. This includes policies designed to promote the development of domestic businesses and curb the power of multinationals when operating within that country's borders.

Examples of laws and regulations applying to all sectors that developing countries have reserved the right to use, and which the EU has requested be eliminated include:

- Barbados: Requiring foreign investors purchasing or selling land or shares/stocks to pay a specific tax on the value of the settlement.
- Bolivia: Requiring foreign companies to establish subsidiaries if they want to trade on a regular basis.
- Botswana: Giving nationals priority in purchasing assets owned by foreigners.
- Brazil: Restrictions on profit repatriation which outline procedures that enable the central bank to restrict transfer of funds abroad by foreign companies.
- Cameroon: Specifying that for every CFA 5 million (equivalent to US$10,000) of foreign investment at least one job must be created.
- Chile: Obliging investors to employ 85 per cent of staff of Chilean nationality.
- Chile: Requiring foreign investors to retain capital in the country for at least three years from the date of entry.
- Cuba: Limiting foreign investment of joint enterprises to 49 per cent.
- Dominican Republic: Subjecting foreign investment to official authorisation and placing a limit on remittance abroad of annual profits (25 per cent of registered capital).
- El Salvador: Placing a 50 per cent ceiling on the remittance of profits abroad.
- Honduras: Ensuring foreign investment is authorised based on an economic needs test.
- Indonesia: Obliging multinationals to form joint ventures when they set up shop inside the country. Indonesia's GATS restrictions state that foreign companies can only control 49 per cent of a joint venture and must work through/with a local representative when setting up branches inside Indonesia.
- Jordan: Prohibiting foreign firms from trading in real estate.
- Malaysia: Allowing land purchases to be denied if the intention is purely speculative and subjecting foreign corporate take-overs to government approval.
- Mexico and Chile: Restricting foreign ownership of land along coastlines.
- Pakistan: Requiring maximum foreign equity participation of 51 per cent and authorising the acquisition of real estate to foreigners on a case-by-case basis.
- Philippines: Requiring foreign investors buying real estate to have 60 per cent local capital.
- Solomon Islands: Stipulating that foreign nationals and foreign-owned companies may not purchase land, but may lease from government or land-holding groups.
- South Africa: Limiting the amount of local borrowing by companies with more than 25 per cent non-resident shareholding.
- Taiwan: Preventing foreign companies purchasing or leasing land in agriculture, forestry, fishing, pasture, hunting, salt production, mines and sources of water.

Sector-specific regulations targeted by the EU in the current GATS talks

Examples of sector-specific regulations that developing countries have reserved the right to use, and which the EU has requested be eliminated include:

- Colombian financial services sector: Offering special conditions exclusively to Colombian companies or nationals in the disposal of state holding companies.
- Egyptian hotel and restaurant sector: Allowing limitations on the total number of services operations on the basis of economic needs test, and laws requiring that casino services can only be provided through 5-star-hotels.
- Indian banking sector: Placing a ceiling of 15 per cent for assets of foreign banks in the total assets of the banking system.
- Jordanian travel agency and tour operator sector: Requiring foreign travel agents to implement their tours through local service providers.
- Kenyan telecommunications sector: Limiting foreign investment to 30 per cent.
- Malaysian insurance sector: A cap of 51 per cent foreign equity participation.

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