

International rules and standards

chapter 9

The approaches to delivering the basics of a sound investment climate discussed in Part II of the Report rest mainly on domestic laws, policies, and institutions. In recent decades the volume and range of international rules and standards dealing with investment climate issues has shot up dramatically. Can these arrangements help governments improve the investment climates of their societies?

Arrangements that reduce regulatory barriers to international trade and investment can improve investment climates in obvious ways—such as by expanding market size, reducing costs, facilitating the diffusion of technology, and enhancing competition within an economy (chapter 5). Arrangements that foster closer regional integration can be especially important for smaller economies (chapter 3). But this chapter takes a broader view and considers the potential advantages—and tradeoffs—in using international arrangements as part of a strategy for improving the investment climate. It focuses on three possible contributions:

- Enhancing the credibility of government policies and commitments to reduce risks faced by firms.
- Harmonizing rules and standards to reduce costs in international transactions.
- Addressing the spillover effects policies in one country can have on others.

International arrangements and the investment climate

International arrangements affecting the investment climate have a long history. In the 12th century cities in northern Europe joined to form the Hanseatic League to protect commerce.¹ At least since the 1920s international law has recognized limits on the ability of governments to expropriate foreign property.²

The number of international arrangements dealing with investment climate issues has grown dramatically in recent decades. There are now more than 2,200 bilateral investment treaties, 200 regional cooperation arrangements, and some 500 multilateral conventions and instruments. These arrangements cover most areas of the investment climate—from property rights protection, taxation, and corruption, to regulation in areas as diverse as banking, shipping, telecommunications, labor, and the environment.

When considering particular arrangements, the detail of the specific rule or standard obviously matters. Some arrangements (or provisions within broader arrangements) focus on the process of international cooperation—such as facilitating cooperation between national regulatory agencies on enforcement issues. Many others deal with the substantive rules that form part of the investment climate facing firms directly, and so in principle could be implemented by governments acting unilaterally. For example, governments can unilaterally provide guarantees against expropriation, liberalize their trade and investment regimes, protect intellectual property rights, and regulate to safeguard their environment in the absence of international commitments. When making judgments on their domestic policies and rules in each area, governments need to consider the costs and benefits of alternative approaches. International arrangements can influence the calculation in several ways:

- Entering an international obligation on a particular issue increases the costs of policy reversal and so enhances policy credibility. This can improve the investment climate by reducing the risks facing firms. But the tradeoff is forgone policy flexibility on the issue in question.

- Adopting common or harmonized rules or standards on some issues can reduce transaction costs in international trade and investment, and so facilitate exports or inward investment. It can also signal compliance with high international standards. But there can be tradeoffs in adopting approaches that are less customized to local circumstances, and in foregoing the benefits from a degree of competition between approaches.
- Pursuing collaborative approaches on some policy issues may be necessary to address spillover effects that national policies can have on other countries. In these cases there can be tensions between national sovereignty and international collaboration as well as over the most appropriate form of cooperation.

Beyond the substantive effect of particular international obligations, calculations may be influenced by two broader considerations:

- Accepting international obligations on some issues may be necessary to obtain benefits in other areas as part of a broader negotiation. For example, the potential benefits from joining an international “club,” such as the World Trade Organization (WTO), the European Union (EU),

or the North American Free Trade Agreement (NAFTA), may lead governments to offer policy commitments on a range of matters that, considered alone, might be less appealing. In these cases governments need to evaluate the package of rights and obligations as a whole.

- Entering international commitments can be used as part of a strategy for pursuing or sustaining domestic policy reforms. Entering commitments to reduce the risk of policy reversal is one manifestation of this, but governments can also use international norms to help build consensus for new policy approaches.³

Given the many tradeoffs in this area, international arrangements vary not only in their content, but also in the level of commitment and in the scope of their participation (box 9.1). These tradeoffs need to be considered in the context of particular proposals. But it is useful to review some of the broader tensions and tradeoffs in the three areas of particular importance from an investment climate perspective: enhancing credibility; fostering harmonization; and addressing international spillovers.

Enhancing credibility

The impact of particular government policies, laws, and regulations in supporting productive investment is ultimately determined by their credibility (chapter 2). Can firms rely on them with confidence when making their investment decisions? Credibility can be undermined by many things, including the pressures governments face to pursue short-term political goals at the expense of longer-term benefits to society. Governments can enhance the credibility of their policy commitments through domestic institutions, such as enshrining key protections in constitutions and creating independent judiciaries (chapter 2). When domestic institutions are at early stages of development their impact on credibility may be weak, however, increasing uncertainty and risk for firms. Entering specific contractual commitments with firms may complement these efforts, but they need to be negotiated firm by firm, limiting the impact on the broader investment climate.

Entering international arrangements on particular policy issues can enhance credi-

BOX 9.1 *Evaluating rules and standards—compliance mechanisms and participation*

The role and impact of any particular international rule, norm, or standard is affected by the mechanisms for securing compliance and by the scope of participation in the arrangement.

Compliance mechanisms. At one end of the spectrum norms may be expressed as formal treaty obligations, and violating them may expose defaulting governments to sanctions of various kinds. In some cases the arrangement includes detailed mechanisms for dealing with allegations of noncompliance (WTO Dispute Panels). At the other end of the spectrum, norms may be no more than a statement of common intent or aspiration, influencing governments mainly through reputation effects, such as Declarations by the Asia-Pacific Economic Cooperation (APEC). In between is a rich menu of hybrid approaches that seek to leverage the reputation concerns of governments. For example, the OECD Guidelines for Multinational Enterprises involve no formal obligations but contain a mechanism for reporting

allegations of noncompliance. The OECD Corporate Governance Principles go further by providing a mechanism for governments to voluntarily have their compliance assessed by an independent third party.

Participation. Some arrangements are bilateral—such as the more than 2,200 bilateral investment treaties concluded since 1959. Others are regional—examples include the EU, NAFTA, the Common Market of the South (MERCOSUR), APEC, and New Partnership for Africa's Development (NEPAD). Still others are multilateral, and so could have global adherence—examples include various U.N.-sponsored arrangements and the WTO. Arrangements with a large number of parties have the potential for broader impact but can also involve arduous and protracted negotiations. For example, the Uruguay Round of multilateral trade negotiations involved active negotiations over nearly eight years, and negotiations for the U.N. Convention on the Law of the Sea took nine.

BOX 9.2 BITs—enhancing credibility one bit at a time?

The first bilateral investment treaty (BIT) dates from 1959 (Germany–Pakistan), and the number has since proliferated. By the end of 2002 BITs covered around 22 percent of the stock of foreign direct investment (FDI) in developing countries.

At the center of most BITs are obligations not to expropriate property without compensation. BITs also typically include provisions governing the repatriation of profits and the transfer of funds. They also include standards of nondiscrimination on admission, establishment, and post-establishment phases of investment. In addition, they provide mechanisms for settling disputes between the two contracting states, and often also between an investor of one state and the government of the host state.

Assurances of this kind can contribute to the investment climate of the host country, and there is some evidence that investors rely on those assurances. Indeed, in some cases a BIT is a precondition for obtaining political risk insurance from bilateral

agencies. Despite this, empirical studies have not found a strong link between the conclusion of a BIT and subsequent investment inflows. Why?

Several factors may be at work. First, as highlighted in chapter 2, firms make their investment decisions based on an assessment of opportunities as a package, and treaty protections alone will rarely be decisive. A BIT addresses only one part of firms' investment equation, and so by itself is not enough to overcome problems with infrastructure or other parts of the investment climate. Indeed, given the costs and delays associated with enforcing treaty obligations, BITs are not a complete solution even to the issues they address. Second, the negotiation of BITs is often driven by governments seeking to foster closer diplomatic ties, rather than immediate interest from investors. To the extent this is so, there need be no direct connection between signing a treaty and subsequent investment activity. Third, there is evidence that many investors are not aware that a

BIT is in place at the time of considering an investment, and indeed investors may remain oblivious until some issue arises when its provisions may be relevant. If so, promoting wider understanding of BITs might enhance investor responses.

For all these reasons, the impact of BITs on investment flows should not be over sold. Well-crafted treaties can nevertheless form a useful part of strategies to address policy risks than can stifle private investment. They can be particularly valuable for countries with weak domestic institutions—including the many countries where firms lack confidence in the courts to uphold their property rights (chapter 4). Indeed China signed nearly 100 BITs in the 1980s and 1990s, at a time when its constitution did not provide protections for private property rights.

Source: Dolzer and Stevens (1995); World Bank (2003b); Hallward-Driemeier (2003); UNCTAD (2003e); and UNCTAD (1998).

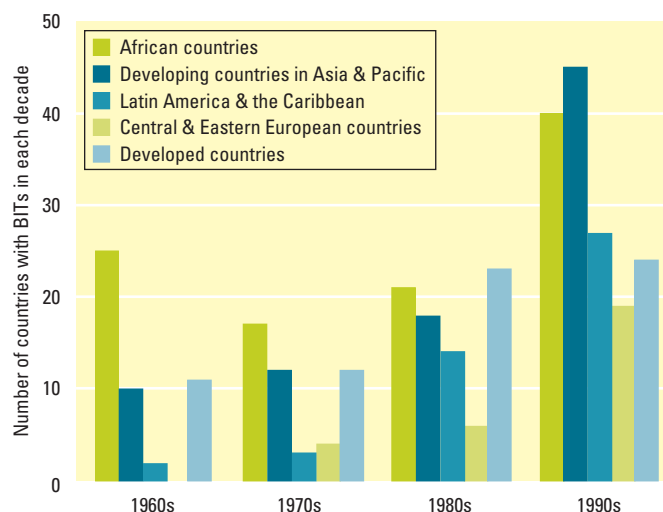
bility by increasing the costs of renegeing on the commitment.⁴ The price of such credibility is forgone policy flexibility. While few governments today would claim the right to expropriate private property without compensation, the prudence of entering binding commitments on many other policy issues is less straightforward. Reflecting these trade-offs, international instruments provide a menu of approaches to calibrate the form and extent of commitment to particular policy issues. Traditional approaches focused on government-to-government treaty obligations, but two other models are rising in prominence for investment climate issues. The first involves a lower level of commitment, through voluntary compliance, and rests mainly on leveraging governments' concerns about their reputations. The second involves a higher level of commitment by allowing private firms to enforce the obligations against the government directly through binding international arbitration.

Traditional government-to-government treaty obligations

Traditional approaches involve governments entering reciprocal commitments, with default by one party creating the possibility of sanctions at the initiative of other government parties. For example, the WTO provides a mechanism for governments to “bind” import tariffs

at particular levels, with any subsequent tariff increase creating an obligation to provide compensation. Dispute settlement mechanisms under the WTO facilitate the enforcement of these obligations and thus enhance the credibility of government trade policy commitments. Similarly, bilateral investment treaties (BITs) include commitments not to expropriate property without compensation, prohibit discrimination between investors, and provide a range of other obligations (box 9.2). The number of countries participating in BITs has grown steadily since 1960 (figure 9.1).

Figure 9.1 Participation in bilateral investment treaties (BITs) has shot up in recent years



Source: UNCTAD (2000b).

Joining a regional economic cooperation arrangement can also enhance policy credibility. For example, in return for access to a fairly liberal internal market, the EU requires member states to comply with a range of policy requirements. The prize of access to a larger market provides incentives for governments to improve their policies to meet EU requirements, and the desire to remain in good standing encourages governments to sustain those policies. Similar factors can be seen at work as NAFTA opens to new members.

In these cases it can be difficult to disentangle several complementary effects. First, access to a larger market can itself enhance investment opportunities. Second, the policy improvements undertaken as a condition of joining the club can improve the investment climate. Third, there is the impact on credibility through reduced likelihood of reversing policy reforms in ways that might jeopardize continuing membership of the arrangement. Indicators of a country's "investment profile"—which focus on perceived risk to investment—suggest that the impact on credibility may be significant (see figure 9.2).

The impact of an international treaty on each party's policy credibility will depend on the specific provisions of the agreement—

and on the parties' incentives to enforce the agreement. Agreements between parties that demand high levels of mutual compliance will have a bigger impact on credibility than agreements involving those with lower expectations.

Arrangements with voluntary compliance mechanisms

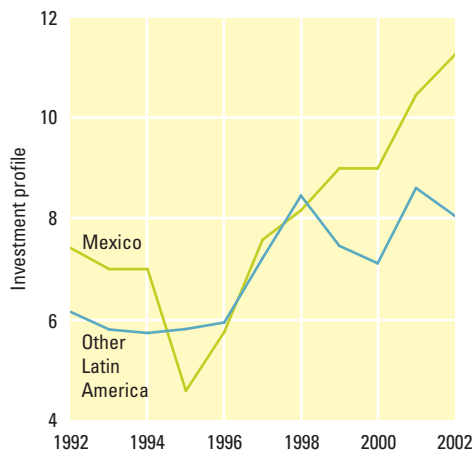
Given the tradeoffs between commitment and flexibility, international arrangements on some issues do not impose binding treaty obligations. These arrangements may nevertheless enhance credibility if they leverage governments' interest in improving or preserving their reputations. For example, the OECD Corporate Governance Principles do not impose binding obligations—governments can ignore them with impunity. They do, however, include a mechanism that allows governments to submit their domestic laws and policies to scrutiny by an independent third party. Governments interested in signaling to investors that they apply high regulatory standards in this area have incentives to submit their policies to scrutiny—and to attain high standards. Countries including Brazil, Georgia, India, the Philippines, Poland, and Turkey have subjected their policies to such assessments.⁵ A similar model is being adopted by the New Partnership for Africa's Development (NEPAD; box 9.3).

As with arrangements resting on more tangible sanctions, the attitudes of other participants toward compliance make a difference—low standards of compliance will lower the impact on credibility. Arrangements that maintain high membership standards will thus deliver stronger benefits than more permissive schemes. When compliance depends on reputation alone, the transparency and integrity of the monitoring mechanism is critical to success.

Arrangements giving private firms direct recourse to governments

Traditionally the remedy for foreign investors who believed they had been harmed by an action of the host government was to pursue their claim against the government before local courts. Investors often felt this was inadequate, with con-

Figure 9.2 NAFTA and Mexico's investment profile



Note: The NAFTA agreement between Canada, Mexico, and the United States went into effect in 1994. "Other Latin America" is an average of 18 other Latin American countries. The ICRG investment profile index reflects factors affecting risk to investment, including contract viability/expropriation, profits repatriation, and payment delays. The maximum value of the index is 12.

Source: Authors' calculations based on the International Country Risk Guide database.

cerns that the local court might be biased in favor of the host government or otherwise not provide an effective remedy. The immediate response was for investors to enlist the support of their home government to pursue the firm's interests through diplomatic channels. This also had its limits and weaknesses. The fate of the firm's claim often depended on diplomatic and political relations between the two governments. In some cases claims might be ignored. In others what was essentially a commercial dispute became politicized, sometimes culminating in interminable negotiations—and sometimes in the use of armed force.⁶

When the rights and obligations of the investor and the host government are set out in contracts, one option is for the parties to agree to submit any contractual disputes to international arbitration by a neutral party. This approach has a long history in international commerce, and is supported by a range of international conventions and institutions.⁷ In 1966 the International Centre for Settlement of Investment Disputes (ICSID) was established by international convention to specialize in investment disputes between host governments and foreign investors.⁸ The convention has since been ratified by 140 countries. Under ICSID firms from one member state can pursue their investment disputes against other member states through binding international arbitration, without the need to involve their home government. The governments can pursue investors directly as well. The parties are responsible for appointing the arbitrators and abiding by the decision. Typically the investor and the host state each choose an arbitrator, and the parties have to agree on a third arbitrator. Sitting in a neutral venue, the arbitrators hear evidence and render an award. ICSID provides the procedural rules and a small secretariat to support the arbitrators and the parties.

As with other forms of arbitration, ICSID's jurisdiction rests on the consent of the parties, often given through clauses inserted in investment contracts. In the 1990s it became common for BITs to include provisions for governments to give their prior consent to ICSID jurisdiction, thus eliminating the need for case-by-case agreement. Similar

BOX 9.3 NEPAD and its peer review mechanism

As part of an effort to improve the quality of governance in Africa, the New Partnership for Africa's Development was created in 2001 by regional governments. It puts enhancing government credibility front and center. An African Peer Review Mechanism is the core instrument.

NEPAD includes principles to improve political governance and economic reform—and to promote competition, trade, investment, macroeconomic and political stability, and sustainable development. The peer review mechanism enhances the transparency and accountability of participating

governments. Each participating country submits to peer review and ongoing monitoring. The country is evaluated on economic and political grounds according to a set of standards that include democracy and political governance, economic governance and management, corporate governance, and socioeconomic development. The review is to be undertaken by experts appointed by an independent panel, with the results made public.

Source: Funke and Nsouli (2003) and NEPAD official documents.

provisions are included in NAFTA. This has expanded access to ICSID jurisdiction, and the volume of cases submitted to ICSID has grown strongly in recent years—more than half the 129 cases it has registered since its inception were filed in the last five years.⁹

The use of BITs and other agreements that include prior consent to ICSID jurisdiction creates a new source of discipline on host governments—and a potentially powerful tool to enhance the credibility of their contractual and policy commitments. Governments and firms can both benefit. Governments benefit from a commitment device that can address concerns from investors, and thus help them attract more investment at lower cost, and also reduce the risk of any later dispute becoming politicized. Firms benefit from reduced risks and a more reliable mechanism for protecting their rights if the relationship with the host government deteriorates. While ICSID is designed to encourage foreign investment, domestic firms can benefit from the halo effect provided by stronger constraints on arbitrary government action.

As with effective courts (chapter 4), the benefits from an effective system of international dispute settlement are not measured in the number of cases heard, but in the incentives it creates for the parties to adhere to their commitments. The threat of possible sanctions that might later be imposed by an arbitration panel can deter governments from renegeing on their commitments and give the parties an incentive to come to a negotiated solution.

Despite the potential advantages, the system of investor-state dispute settlement has raised several debates. Does it impose too much discipline on governments? Does that discipline encroach on governments' regulatory prerogatives? And is the process sufficiently transparent?

Too much discipline? Some governments have recently been subjected to claims from firms for substantial damages as a result of alleged breaches of contractual or treaty commitments. The sums actually awarded by arbitration panels, if any, depend on findings of liability and on the losses experienced by firms, but for large infrastructure or resource investments the sums might be substantial. Is this too heavy a burden to place on governments? The main alternatives would be to return to an approach that led to the politicization of investment disputes, or to allow governments to ignore their commitments with impunity. While the second path might appear attractive for governments in the short term, the consequence would be that no firm could rely on a government's commitments, and this risk will be reflected in investment decisions (chapter 2).

Encroaching on regulatory prerogatives? Most BITs and similar agreements include a prohibition against expropriation without compensation, and there is general consensus that prohibitions against outright seizure of property are appropriate. There is concern, however, about how prohibitions against "indirect" expropriation might affect a government's regulatory prerogatives. It is clear that some governments have used arbitrary regulation or taxation to achieve a result equivalent to expropriation, and most observers agree that such behavior should be caught by the prohibition. But concern has been expressed that the provisions might be interpreted to restrict legitimate regulatory action by host governments, or that even the potential for such claims might induce a "regulatory chill." Similar issues have been debated under guarantees against expropriation contained in national constitutions, where the result has been to preserve legitimate regulatory prerogatives

(chapter 4). Arbitration panels have so far tended to interpret the treaty provisions equally cautiously,¹⁰ and can also deter frivolous claims by the threat of sanctions.

Sufficient transparency? Investor-state dispute resolution involves agreement by the parties (including ratification by governments of relevant treaties), and both parties are equally involved in determining the composition of the arbitration panel. Arbitration evolved from diplomatic and commercial practice, where it was customary for proceedings to be confidential. This has led some observers to question whether the arrangements are sufficiently transparent, particularly when matters of broad public interest are involved. While practice under different arbitration regimes varies, ICSID has always promoted transparency, and efforts are underway to further increase the opportunities for public participation in dispute proceedings, making the procedure more analogous to a court hearing. ICSID also has a procedure for challenging awards. As the system evolves, there will likely be pressures for even greater transparency (box 9.4).

Fostering harmonization

In the normal course of events each country or jurisdiction tends to develop its own rules and standards on particular issues to reflect local customs, conditions, and priorities. This adaptation is an important part of ensuring a good institutional fit—and one reason to be cautious in uncritically transplanting regulatory systems from other countries (chapter 2). A mixture of adaptation and experimentation can also lead to the discovery of new and better ways of achieving particular policy goals. Institutional competition between jurisdictions can also encourage governments to attain higher standards.¹¹

Divergent approaches to some regulatory issues, however, can increase the costs of international trade and investment transactions. If goods or services need to meet different standards and regulatory requirements in every country, customization can drive up the costs of production and distribution and reduce competition. Diverse

BOX 9.4 The evolving system of investor-state dispute settlement

The recent rise in the number of investment disputes brought before ICSID arbitration panels has put investor-state arbitration in the spotlight.

Arbitration proceedings were traditionally confidential, but ICSID's rules require making a dispute public and encourage parties to publish information about the dispute and its outcome. Concerns about the transparency of international arbitration between investors and states are also leading to procedures that more closely resemble those of judicial proceedings. For example, in a recent case brought against the United States under NAFTA, the parties agreed to use an *amicus curiae* (friend of the court) procedure allowing nondisputing parties to make submissions to the arbitration panel. The U.S. government has also modified its model BIT agreement, incorporating provisions for greater transparency in new agreements. The Chile–U.S. Free Trade Agreement contains a requirement that arbitration panels conduct the hearings open to the public and disclose key documents.

The acceptability of investor-state arbitration also depends on the perceived fairness of the results. The state party prevailed in half of the 24 disputes that went to final award between 1987 and 2003.

Cases brought to ICSID, 1987–2003	Under NAFTA	Under BITs
Cases registered	10	87
Cases concluded (including settlement)	6	31
Final awards rendered	6	18
Cases in which investor prevailed	2	10
Cases in which state prevailed	4	8
Average duration (from constitution of tribunal or ad hoc committee), months	29.5	28.2

Note: Data through February 2003.

Source: ICSID Web site, World Bank staff, and official texts of the mentioned agreements.

approaches can also increase the costs foreign firms face when evaluating alternative investment locations, perhaps deterring them from pursuing investments in countries with unfamiliar arrangements. Beyond reducing transaction costs, adoption of international standards can also facilitate domestic policy reform when local interest groups have conflicting preferences.¹² Adoption of international standards can also signal to firms, consumers, and other groups the application of high regulatory standards.

The tensions between local customization and international harmonization play out in proposals to develop common international rules and standards on a wide range of issues relevant to the investment climate. Efforts to develop uniform standards to ease international commerce have long been a focus of private bodies such as the International Chamber of Commerce.¹³ Complementary efforts at the intergovernmental level include those of the United Nations Commission on International Trade Law¹⁴ (UNCITRAL) and a variety of other international agencies. In francophone Africa, for example, harmonization of business law is being facilitated by the Organisation pour l'Harmonisation en Afrique du Droit des Affaires (OHADA, box 9.5). The possible areas for cooperative action range from developing a common set of international rules on contract law to harmonizing international accounting standards. Clearly the costs and benefits of each approach need to be considered case by case.

To be effective, common international standards do not always require binding treaty obligations. Countries, or even firms, can voluntarily adopt common norms, with the incentives to comply driven by reputation. Some international agencies have also developed “model laws” to encourage convergence on common approaches, but leaving countries the freedom to adapt approaches to local circumstances; the UNCITRAL model law on international commercial arbitration, for example, has been adopted by more than 35 jurisdictions.

There can also be alternative strategies for achieving the same end. For example, rather than adopting identical rules in each jurisdiction, participating governments may agree, in mutual recognition schemes, to accept in

BOX 9.5 Harmonizing business law in Africa—OHADA

The Organisation pour l'Harmonisation en Afrique du Droit des Affaires (OHADA), established in 1993, promotes the harmonization of business law in Africa. It has 16 member states: Benin, Burkina Faso, Cameroon, Central African Republic, Comoros, Congo, Côte d'Ivoire, Gabon, Guinea, Guinea-Bissau, Equatorial Guinea, Mali, Niger, Senegal, Chad, and Togo.

Under OHADA, the texts of “Uniform Acts” are endorsed by a Council of Ministers and then made directly applicable in each member country. So far the harmonization process has resulted in uniform acts in six areas: general commercial law, companies, securities, debt recovery, bankruptcy and insolvency, and arbitration. A Senegalese

firm investing in Togo will thus be dealing with many of the same regulatory requirements as in its own country, and a foreign investor familiar with the laws in one country can apply the same understanding to other OHADA countries. The result should be lower transaction costs and reduced uncertainty.

The OHADA Treaty also establishes a Common Court of Justice and Arbitration, which acts as an advisory body to the Council of Ministers, serves as an appeal body to foster common interpretations of the Uniform Acts, and supports the resolution of commercial disputes.

Source: Ba (2000) and OHADA official documents.

their jurisdiction goods or services that meet the regulatory requirements of another participating jurisdiction. This approach has done much to facilitate commerce within the EU, between the EU and some nonmember states, and between Australia and New Zealand. Similar approaches could have wide application across a range of investment climate issues.

A more ambitious form of harmonization is to agree not only on common rules but also to delegate responsibility for administering them to a common regulatory body. This presents opportunities for greater consistency in interpretation, lower administrative costs, and possibly enhanced credibility for participating governments. In practice supranational regulatory bodies are more often proposed than implemented, in part because of concerns over national sovereignty. There are exceptions. For example, OHADA has a common court to foster consistent interpretations of harmonized business laws, and the Eastern Caribbean Telecommunications Authority regulates telecommunications in five small countries in the Caribbean. Progress usually requires a governance framework that gives each participating government effective voice—and a high level of trust between participants.

The advantages and disadvantages of harmonization proposals also depend on the number of countries participating in the arrangement. Multilateral approaches offer

the largest benefit, but increase the challenge of developing approaches that will meet the interests of all participating governments. They can also involve protracted negotiations. Reflecting these tradeoffs, the number of regional economic cooperation arrangements has grown strongly in recent years (figure 9.3).

For the liberalization of trade and investment, there is an ongoing debate over whether regional arrangements are building blocks or stumbling blocks to a liberal multilateral system.¹⁵ Proposals that focus on the harmonization of standards tend to pose fewer concerns of this kind, although there can be other tradeoffs. For example, harmonizing standards at the regional level can reduce transaction costs for intraregional trade and investment, but harmonizing standards with major capital exporters or export markets outside the region might offer even greater benefits.

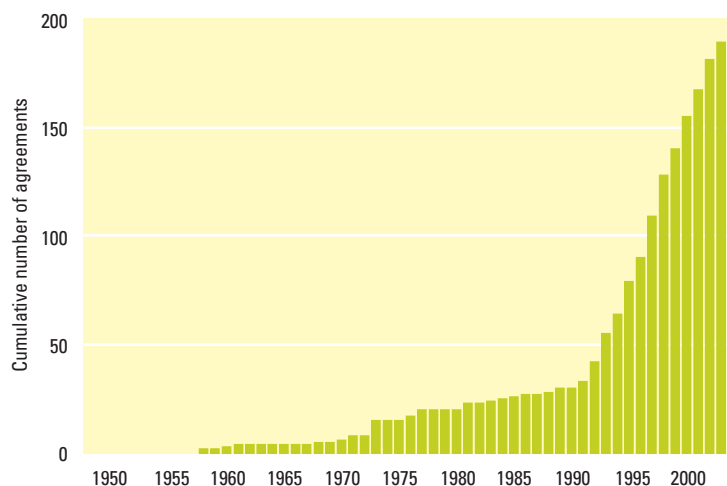
Addressing international spillovers

Many international arrangements, existing and proposed, seek to address international spillovers of some kind—where actions in one country can have effects on others.

The clearest cases involve environmental protection. For example, emissions or effluents from industries in one country may harm the environment in other countries. When this happens, international cooperation may be needed to mitigate the negative externality and achieve an efficient outcome. Indeed, there has been a growing volume of international rules on various matters affecting the environment since the 1970s.¹⁶ Not all environmental issues have an international dimension, however, and thus warrant international action. For example, when the adverse effects of pollution are contained within a country's borders, the case for overriding the sovereignty of that government is weak.¹⁷

Outside environmental protection, there are also many areas where the argument for international cooperation can be strong. This is the case with international efforts to combat corruption, for example, which can seriously undermine investment climates (box 9.6).

Figure 9.3 Regional economic cooperation agreements proliferated in the 1990s



Note: Agreements reported to the WTO.
Source: WTO Web site.

When spillovers are less tangible, or the benefits less evenly shared, the case for international cooperation can be more complex. Take competition policy. There is growing understanding of the importance of adopting cooperative approaches to the investigation and prosecution of international cartels, which can impose large costs on countries. In the 1990s about 40 international cartels were prosecuted in the EU and United States alone. The average international price increases due to those cartels are estimated to have been around 20–40 percent. It was also found that many of these cartels specifically targeted developing countries without appropriate national legislation in place. The imports of 12 cartelized products by developing countries in 2000 alone exceeded \$10 billion.¹⁸ Even when the argument for action is strong, however, there is room for debate about the best form of that action. Should it be limited to coordination between national agencies? Should efforts focus on providing technical assistance to help national governments establish effective national regimes? Or is a multilateral agreement on competition policy required?¹⁹ The last option could have significant implications for developing countries, most of which have not yet established competition agencies.

Proposals to develop new international rules to address issues associated with competition for investment between countries can be even more problematic. Competition between governments to attract or retain investment plays an important role in driving investment climate improvements (chapter 3). But it has led to concerns that there may be a “race to the bottom” in tax rates, environmental regulation, or other matters. As discussed in chapter 5, the theoretical support for such races is mixed, and so far the dire predictions of some commentators do not seem to be taking place. Indeed, in some cases the race seems to be to the top rather than the bottom. But the concern illustrates some of the tensions and practical challenges for international cooperation on matters where countries can have divergent perspectives.

Take tax harmonization. Countries that prefer high tax rates may favor international

BOX 9.6 *International cooperation to combat corruption*

National antibribery laws date from at least the Law of Moses in the 9th century BCE. The first attempt to address bribery on an international level came in the 1976 OECD Guidelines for Multinational Enterprises. This foreshadowed the most significant step to date, the ratification of a multilateral convention committing parties to make the bribery of a foreign official by one of its citizens a criminal offense.

The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, signed in 1997 by all 30 OECD member countries and 5 nonmember countries (Argentina, Brazil, Bulgaria, Chile, and Slovenia), went into force in 1999. The Convention provides guidelines and a monitoring mechanism to improve domestic antibribery laws and outlines areas where coordinated action to reduce corruption should be taken. To ensure the parties live up to their agreement, the Convention establishes procedures to monitor compli-

ance. Transparency International complements official monitoring with a series of public reports on each country's progress in stemming the bribery of foreign officials.

An even more ambitious effort to foster international cooperation is the U.N. Convention against Corruption, signed in 2003 by 106 countries and entering into force in 2005. It stems from two previous U.N. arrangements—the U.N. Declaration against Corruption and Bribery in International Commercial Transactions and the U.N. Convention on Transnational Organized Crime—and complements the OECD convention. It addresses cross-border issues associated with recovering assets, freezing accounts, and seizing foreign property of corrupt officials.

Source: Official texts of Conventions, Transparency International (2004), and Braithwaite and Drahos (2000).

rules on taxes with the goal of slowing the movement of firms to countries that prefer lower taxes—but the latter countries have no incentives to cooperate. Such differences in perspective have stymied progress in reaching agreement on these matters, even between countries at similar levels of development, such as in the EU.²⁰ The prospects of achieving a truly global accord on minimum tax rates that incorporates countries with even more divergent perspectives seems a distant prospect at best.

When these differences exist, the challenge extends beyond the feasibility of negotiating an agreement. Even if uniform international tax rates could be agreed on and enforced, countries could simply shift competition for investment to other dimensions of their investment climate policies, such as the provision of infrastructure or the enforcement of a host of other regulations.²¹ Indeed, given the breadth of policy areas that influence the investment decisions of firms, efforts to curb competition would need to cover a vast field—leaving little scope for sovereign states to reflect differences in social preferences or in levels of development. Without evidence that such competition is leading to real welfare losses,

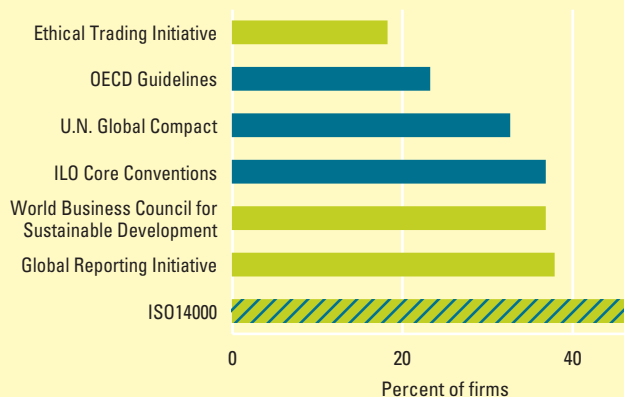
BOX 9.7 Privatizing international cooperation on corporate social responsibility

Efforts to promote international cooperation on matters related to the investment climate are not limited to arrangements between governments. There has been a growing trend to develop international norms applicable to firms directly, without the intermediation of states. Particularly in the area of corporate social responsibility, many of these initiatives also spring from the nongovernmental sector.

These codes of corporate conduct outline basic principles of behavior for firms, including corruption and respect for environmental and labor norms. Not legally binding, the codes typically depend on the reputation concerns of major firms that operate in more than one country, with compliance often reinforced through third-party inspection and transparency arrangements. Examples of such initiatives include the Global Reporting Initiative, the U.N. Global Compact, the Equator Principles, the Publish What You Pay Initiative, and Transparency International's Business Principles for Countering Bribery.

These mechanisms may help firms adopting high standards to signal their compliance and to burnish their reputations, thus complementing national laws and policies. The proliferation of new codes and arrangements can, however, create confusion about acceptable standards. Because these initiatives affect mainly multinational firms that have an interest in enhancing

Standards are influencing business



Note: Percentage of firms that indicated standards influenced their business. Standards emanating from intergovernmental initiatives are in dark blue, those by nongovernmental organizations are in light green. The International Organization for Standardization (ISO), striped in this figure, is a nongovernmental organization, but has members drawn from public and private sectors. ILO stands for International Labour Organisation.

or maintaining their international reputations, they will also have less impact on the behavior of other firms.

A recent survey showed that many firms take standards of corporate social responsibility into account when making location and production decisions—and suggests that those ema-

nating from the nongovernmental sector were often as influential as those developed by international agencies (see figure).

Source: Jorgensen and others (2003); Smith and Feldman (2003); UNCTAD (2001a); Berman and Webb (2003).

the case for intruding on the prerogatives of national governments seems weak.

An alternative strategy is to leverage the concerns firms have for their reputations. As discussed in chapter 2, a growing number of initiatives aim to address concerns about international economic integration by targeting firms directly, rather than governments. Many of these initiatives emanate from the nongovernmental sector (box 9.7).

Future challenges

International rules and standards can be expected to do more in shaping investment climates as the intensity of interactions between governments and cross-border trade and investment expand. As this brief survey highlighted, progress in that direction will need to grapple with several general tradeoffs.

Measures to enhance the credibility of government commitments can be especially

important for countries with domestic institutions at an early stage of development. Stronger commitment devices offer greater benefits, but they also involve forfeiting more policy autonomy—and so need to be considered carefully. To be sustainable, measures that curb domestic policy autonomy must also be accepted as legitimate, reinforcing the importance of efforts to enhance transparency.

Measures to reduce costs through international harmonization offer many benefits but involve several tensions. There is the tension between harmonization and customization—taking local circumstances into account. There is the tension between harmonization and competition—where some degree of competition between standards can be an important part of the learning process. There is the tension between multilateral and other approaches, and in the latter case between harmonization with

neighbors and harmonization with major markets or sources of capital. Given the tradeoffs involved, the preferred approach will often vary from issue to issue—there will be no universal models.

Measures to address international spillovers also need to reflect the divergent perspectives of countries at different levels of development. Care needs to be taken not to curtail the policy space of emerging nations without a compelling rationale. At a minimum the voices of developing countries need to be heard when framing these initiatives.

While the emerging network of international rules and standards can help governments improve the investment climates of their societies, a critical challenge is to ensure the arrangements reflect the interests of developing countries. Uniform global rules may be appropriate for some matters, but differences in priorities and capabilities need to be reflected in others (box 9.8).

The international community has a responsibility to help ensure that new international rules and standards reflect the perspectives of developing countries. The best way to do so is to ensure that developing countries have the opportunity to participate fully in the development of those arrangements. Recognizing this, multilateral and bilateral donors mobilized more than \$700 million in technical assistance to support developing country participation in the Doha Round of multilateral trade negotiations.²² Given the increasing role of international arrangements in the investment climate area, similar support may

BOX 9.8 *A multilateral agreement on investment?*

Proposals to develop a multilateral agreement on investment have a long history. The first attempt was in 1929 at the Paris Conference on the Treatment of Foreigners. The experiment was repeated again in the 1948 Havana Charter. In 1959 two private initiatives were combined as the Abs-Shawcross Draft Convention on Investment Abroad. In 1967 the OECD produced a Draft Convention on the Protection of Foreign Property. In 1995–98 the OECD attempted to develop a Multilateral Agreement on Investment. Investment issues were proposed for inclusion in the Doha Round of the WTO launched in 2001. In each case the proposal failed to find sufficient support.

Looking back, each proposal had its own features and encountered different obstacles. But there are basic challenges in constructing an agreement that includes investment protection provisions (along the lines of BITs) and market-opening provisions, that meets the interests of capital exporters and importers, and that reflects the interests of both developed and developing countries.

For a developing country, a multilateral agreement that provides high standards of protection for investment should have many attractions as a tool to reinforce the credibility of government policies. A multilateral agreement would also reduce the transaction costs associated with negotiating scores of BITs, and reduce inconsistencies between those agreements. Recent

experience under NAFTA, however, suggests that proposals in this area need to place special emphasis on clarifying the interactions between prohibitions on indirect expropriation and domestic regulation—and enhancing the transparency of investor-state dispute settlement mechanisms. The treatment of restrictions on foreign capital flows may also be subject to debate (chapter 5). In principle it should be possible to craft an agreement that meets these interests, but the same agreement would need to meet the interests of developed countries, which will typically place greater emphasis on market-opening measures, including between themselves.

A broad negotiating forum provides opportunities to trade concessions across a range of subject areas, but it can also involve complex negotiations that can easily be derailed. Another option could be to develop or expand regional agreements with effective investment provisions. NAFTA could be an example. However, this approach offers little help to low-income countries in other regions, which would stand to gain the most from effective commitment devices. And creating a regional investment agreement covering only developing countries would likely offer only limited benefits because it would exclude the principal sources of investment capital.

Source: Ferrarini (forthcoming); Henderson (2000); World Bank (2003b); Parra (2000); and Warner (2000).

need to be mobilized across a range of new areas. Other ways that the international community can help developing countries improve the investment climates of their societies are the subject of chapter 10.

