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INVESTMENT PERFORMANCE REQUIREMENTS
AND INCENTIVES

The attached paper is distributed at the request of the member from the United States in connexion with item 7 of the Annotated Provisional Agenda (CG.18/W/50) for the fourteenth meeting of the Consultative Group of Eighteen to be held on 25-27 March 1981.

INVESTMENT PERFORMANCE REQUIREMENTS
AND INCENTIVES

At the last meeting of the Consultative Group of 18, the United States delegate proposed that the GATT undertake an inventory of investment performance requirements and incentives. It was agreed that at the next meeting of this group the United States would present a paper on this proposal and the reasons why the GATT should perform such an inventory. This paper responds to that agreement.

Proposal

The GATT should undertake an inventory of investment performance requirements and incentives. The purpose of this inventory is to identify the nature of these measures and the extent to which they are currently used by governments. The information to be gathered, which will be the first complete picture of the world-wide use of these measures, will form the basis for any further analysis or action the GATT may decide to undertake. The inventory can be performed by the GATT secretariat and should follow the format of the inventory of non-tariff measures undertaken during the Multilateral Trade Negotiations (MTN). Member countries would be asked to identify both their own performance requirements and incentives as well as those of other countries which they are aware of or which cause them concern. The inventory should be initiated at the earliest possible time and be completed within a specified period, preferably no more than one year.¹

Definitions

Investment performance requirements, generally defined, are any requirements placed by a host nation government upon a foreign controlled enterprise. These requirements for specific performance may be conditions under which various investment incentives are provided (in which case

¹In undertaking this work programme and to avoid unnecessary duplication of effort attention should be drawn to the conceptual and empirical work on these issues being performed in other international organizations. These include the IMF/IBRD Development Committee and the OECD Committee on International Investment and Multinational Enterprises. A brief summary of the analytical and empirical work performed by these organizations is provided in Annex A.

similar requirements may be placed on domestic enterprises) or may be conditions for foreign investors to attain entry to a country. Major types of performance requirements are listed below:

- (1) export requirements;
- (2) requirements regarding import substitution;
- (3) requirements relating to size (e.g. capital invested or employment levels);
- (4) requirements regarding industrial sectors or specific industries;
- (5) requirements regarding location of industry;
- (6) requirements limiting foreign ownership (or providing for local participation);
- (7) requirements regarding employment of foreign nationals (or the employment of nationals, especially in technical and managerial positions);
- (8) requirements relating to investor financing and access to local capital;
- (9) restrictions on the remittance of earnings and the repatriation of capital;
- (10) requirements concerning the introduction of new products and new or high-level technology.

We propose that the GATT deal at this time with the measures having the greatest direct impact on trade, i.e. the first two listed above.

Export requirements can take a number of forms: (a) a company may be required to export a minimum percentage of its annual production (e.g. 30 per cent of annual output); (b) a company could be required to meet some absolute export target (e.g. \$1 billion in exports over five years); and (c) a company could be required to earn sufficient foreign exchange through exporting to cover the foreign exchange costs of inputs the company imports.

Import substitution requirements also take several forms, including: (a) mandatory local assembly or final stage of manufacture of previously imported end-products; (b) local content requirements which necessitate the local manufacture or procurement of intermediate parts which the company could otherwise choose to import; and (c) local value-added requirements which mandate a minimum percentage of domestic value-added in production.

Trade-related performance requirements can lead to distortions in trade flows and in the use of economic resources. For example, local content requirements mandate the use of domestic factors of production irrespective of relative costs. Similarly, export requirements force a firm to export a certain amount of its production, irrespective of comparative advantage. Such exports can cause trade diversion through displacement of another country's exports to third country markets or through increased imports from the firm complying with the export requirements. Possible losses incurred in such exports can be made up by exploiting what are often monopoly-like positions in the host country. These requirements have effects similar to trade protection or subsidies in altering international trade flows and adversely affecting other countries. Trade distortion is most severe when such requirements are used in conjunction with each other (e.g. local content and export requirements in the same industry) or when they are used in conjunction with other restrictive measures (e.g. tariffs) or incentives.

In general terms, an investment incentive can be defined as a government action or policy which increases the net cash flow of an investment over what would have been anticipated without the government intervention. Incentives take a wide variety of forms and can apply across the board to all investments, to only particular industry sectors and geographic areas, or can be tailored to specific projects on a case-by-case basis. Incentives for investment can be broadly classified into fiscal, financial and non-financial measures. Specific types of investment incentives include tax concessions, cash grants, customs waivers, low-cost loans or operating subsidies or provision of infrastructure. Incentives are granted by local and State or provincial governments as well as federal governments. The inventory should focus on those measures most likely to affect international trade flows. Therefore, we suggest the inventory be based on, but not necessarily limited to, those incentives enumerated in the Subsidies/Countervailing Measures Agreement.¹ The incentives or domestic subsidies listed there are "government financing of commercial enterprises, including grants, loans or guarantees; government provision or government-financed provision of utility, supply distribution and other operational or support services or facilities; government financing of research and development programmes; fiscal incentives; and government subscription to, or provision of, equity capital".

¹ Article 11(3) of the Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade. The relationship between this Agreement on Interpretation and the inventory encompassing investment incentives will be explained in the following section of the paper.

The Subsidies/Countervailing Measures Agreement also states that these measures are "illustrative and non-exhaustive" and currently reflect those used by a number of signatories to the Agreement. Therefore, the inventory should not be precluded from expanding upon this list when it is judged that other types of incentive measures can also distort trade.

Investment incentives may cause changes in international investment and trade patterns by shifting the location of investments from one region or country into some other region or country of similar characteristics. In addition, the conditions of normal competition may be adversely affected because companies receiving such incentives can displace production in third country markets, as well as former home country markets, through exports from the subsidized facilities.

The GATT and investment measures that affect trade

The rest of this paper will present the reasons why the GATT should undertake the inventory that has been outlined above.

During the more than three decades that the GATT has existed, many changes have occurred in the international economy and the economic policies of governments that were not foreseen or addressed by the original Contracting Parties. Those changes that were judged to have significant or potentially significant effects on the objectives of the GATT have been addressed in various ways by the CONTRACTING PARTIES by amendments to the provisions of the GATT or agreements on the interpretation of existing provisions in the light of the changed circumstances. The most recent examples of expanding the scope of the GATT in order to preserve its objectives were the agreements reached on non-tariff measures during the MTN. These agreements were a response to the growing intervention of governments in their domestic economies which, while normally intended to meet legitimate social objectives, also had economic effects on other countries through restricting trade. The agreements on standards, customs valuation, government procurement, subsidies and countervailing measures, etc. were designed to ensure that such practices did not nullify or impair benefits under the GATT and to expand the coverage of practices that the GATT would address.

Government practices not covered during the MTN, but potentially even more significant than non-tariff measures, are measures designed to alter the flow of international investment or to affect the commercial operations of foreign direct investors. Such measures, which have been summarized by the terms investment performance requirements and incentives, are responses by governments to the rapid growth in foreign direct investment in the past 15-20 years. Performance requirements and incentives are used by governments to control the effects of foreign direct investment on their domestic

economies and maximize the economic benefits for their economies. However, as in the case of non-tariff measures, and as outlined in the previous section, these measures also have effects on other countries. It is the international trade effect of these investment measures, and not the measures per se, that is a legitimate concern of the GATT.

Certain types of trade-related performance requirements may be inconsistent with particular GATT provisions. For example, a requirement that an investor maintain a minimum percentage of domestic value-added in production could, under certain circumstances, violate four separate GATT provisions:

Article II, Section 1(a), prohibits import restrictions beyond those specified in the appropriate GATT schedule of the country for products on which the country has a GATT tariff binding;

Article III, Section 1, prohibits internal quantitative regulations requiring the use of products in specified amounts "so as to afford protection to domestic production";

Article III, Section 5, prohibits internal quantitative regulations requiring that specified amounts of any product be supplied from domestic sources;

Article XI, Section 1, prohibits restrictions other than duties, taxes, or other charges whether made effective through quotas or other measures on the imports of any contracting parties.

Other types of trade-related performance requirements may not be inconsistent with specific GATT provisions but could adversely affect countries by distorting trade. These and other issues may be examined once the inventory has been completed.

Article 11 of the Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade recognizes that subsidies other than direct export subsidies are widely used as important instruments for the promotion of social and economic policy objectives. Paragraph 3 of Article 11 provides an illustrative list of these subsidies which includes many of the same policy measures that have been called investment incentives in this paper. The Subsidies/Countervailing Measures Agreement does not proscribe the use of such subsidies or investment incentives. However, it does exhort signatories to the Agreement to take into account, as far as practicable, the possible adverse effects on trade that such measures may have. Article II(2) states that "subsidies other than export subsidies ... may cause or threaten to cause injury to a domestic industry of another signatory or serious prejudice to the interests of another signatory or may nullify or impair benefits accruing to another signatory under the General Agreement, in particular where such subsidies would

adversely affect the conditions of normal competition. Signatories shall therefore seek to avoid causing such effects through the use of subsidies".

Article 9 of the Subsidies/Countervailing Measures Agreement prohibits "export subsidies on products other than certain primary products". Investment incentives which are conditioned upon compliance with export performance requirements could be considered export subsidies and in violation of Article 9. Consultations may be requested if export requirements tied to investment incentives are imposed. If a mutually acceptable solution is not reached, the issue may be referred to the Committee of Signatories which can authorize countermeasures.

That portion of the inventory dealing with investment incentives would therefore be building on the recognition given to these practices (in the Subsidies/Countervailing Measures Agreement) as possibly trade distorting, and therefore legitimate concerns of the GATT.

It has been shown above that precedents exist for the GATT to expand the scope of its concern to practices such as investment performance requirements and incentives because of the effects such practices have on international trade. It was also shown how some of these policy measures may be inconsistent with existing GATT provisions or at least are recognized in the GATT as potentially affecting trade between contracting parties. The ultimate reason for proceeding with the proposed inventory is that a failure to do so could significantly threaten the progress made during the MTN on non-tariff measures in advancing the objectives of the GATT. It is certain that the use of the investment measures described in this paper will continue to increase as governments attempt to deal with the increasing importance of foreign direct investment in both domestic and international commerce. The GATT must keep pace with these economic developments in the international economy to preserve the achievements it has made in the past and to continue to provide the institutional framework for maintaining a prosperous world economy.

ANNEX A

Summary of Recent Work in Other International
Fora Concerning Investment Performance
Requirements and Incentives

1. Task Force on Private Foreign Investment of the Joint Development Committee of the International Monetary Fund (IMF) and World Bank (IBRD).

The Task Force, consisting of delegates at the subministerial level from 12 developed and developing countries, examined home and host government policies that affect international direct investment. The Task Force completed its work in July 1980 and submitted a report of its findings and recommendations to the Development Committee.

A major part of the work of the Task Force was an examination of investment performance requirements and incentives.¹ The conclusion of the Task Force was that the "central issue with foreign investment incentives and performance requirements is how to reconcile host countries' legitimate needs to pursue their national interests through their use with the need to ensure that investment capital is channeled to its most productive uses." The Task Force report therefore endorsed the objectives of seeking an understanding which would limit the adverse effects of foreign investment incentives and of considering what further actions might need to be taken concerning performance requirements.

¹ See especially the following papers prepared for the Task Force: M. Narasimham, "Performance Criteria Stipulated by Host Countries" DC/TF/PFI/80-1 (January 8, 1980); C. Fred Bergsten, "Host Country Policies: Performance Requirements" DC/TF/PFI/80-3 (January 25, 1980); David Roberston, "Investment Incentives in Home and Host Countries" DC/TF/PFI/80-5 (January 25, 1980).

The Task Force recommended a study be performed to analyze existing foreign investment incentives and performance requirements and to consider how their impact can be assessed. Depending on the outcome of the study, "an attempt could be made to develop a concept and terms upon which an understanding might evolve." At the present time the study has not received funding.

2. Organization for Economic Cooperation and Development-Committee on International Investment and Multinational Enterprises (CIME).

The CIME Working Group on International Investment Policies began a work program concerning international investment incentives and disincentives (performance requirements) in 1979. The terms of reference of the work program stipulated that the "proposed work would focus initially on examining the effects of government investment incentives and disincentives on the international investment process so as to achieve a better understanding of the determining factors at work on this process. This analysis should provide indications of the impact of such measures on international direct investment flows."

So far, the CIME Working Group has focused on work related to a cataloging and description of investment incentive practices of the Member States of the OECD.² This has included analytical work of a conceptual and definitional nature to establish priorities for the survey of practices and a study of their effects. The Working Group decided to focus specifically on investment incentives and their effect on international investment flows. Performance requirements were only considered in the survey if they were attached as a condition for receiving incentives. The Working Group is scheduled to complete all the work related to the survey by the Spring of 1981. At that stage it is expected that the Group will direct itself to evaluating the international implications of investment incentives.

² See especially "Conceptual Framework for the Study on International Investment Incentives and Disincentives," DAF/IME/79.28 (November 19, 1979); "Survey on Investment Incentives Applied in Member Countries," DAF/IME/80.2 (February 11, 1980); "Survey on Investment Incentive Policies: Information Provided by Member Countries," DAF/IME/80.29 (October 13, 1980); and "A Survey of Incentives and Performance Requirements," DAF/IME/78.3 (April 21, 1978).