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Testimony of Kevin P. Gallagher[1]

Hearing on Investment Protections in U.S. Trade and Investment Agreements

House Committee on Ways & Means, Subcommittee on Trade
Rep. Sander M. Levin, Chair
May 14, 2009

Mr. Chairman, Members of the Subcommittee, thank you for the opportunity to speak to you today about this critical issue on behalf of the Working Group on Development and the Environment In the Americas, a group of economists that I co-chair from across the Western Hemisphere that has been studying the economic impacts of foreign investment liberalization under US investment and trade agreements in our respective countries.

We particularly applaud you for expressing concern about the extent to which "the FTAs and BITs give governments the "regulatory and policy space" needed to protect the environment and the public welfare." It is to these concerns that we address this testimony.

As I mentioned, we conducted a comprehensive review of the impacts of foreign investment liberalization in Latin America and show how foreign investment liberalization through Bi-lateral Investment Treaties (BITS) and Preferential Trade Agreements (PTAs) has fallen far short of stimulating broad-based economic growth and environmental protection in the region. Given this finding, in a report for policy-makers and in a peer-reviewed book we recommend that the "policy space" for policies that enable foreign investment to stimulate growth and sustainable development should be accommodated in future BITS, PTAs and in the global trade regime.[2]

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[2] The policy report, titled Foreign Investment and Sustainable Development: Lessons from the America can be downloaded at: http://ase.tufts.edu/gdae/WorkingGroup_FDI.htm. The book and full-length studies, Rethinking Foreign Investment for Sustainable Development: Lessons from Latin America, is available at: http://www.amazon.com/Rethinking-Foreign-Investment-Sustainable-Development/dp/1843313162

Our research, outlined below, suggests a number of specific measures that should be honored in terms of policy space for development-oriented policies in US BITS and FTAS:

- The right to exercise pre-establishment screening of firms wishing to enter a market, including but not limited to an environmental impact assessment of the investors.

- The right to deploy capital controls and other counter-cyclical policies to prevent and recover from economic crises.

- The right to deploy selective performance requirements such as, but not limited to, joint venture requirements, environmental technology requirements, and other instruments that will encourage broad-based growth in the host country.

- The right, post establishment, for host nations to seek and publicize information from a potential investor, including environmental, labor, and social information.

- Our research also suggests that host nations should also deploy their own national innovation, competitiveness, employment, labor rights, and environmental regulations. And most importantly that upon entering an agreement with the United States that these issues become part of an institutionalized and longer run agenda for reform and harmonization.

- Finally, our research suggests that treaties should designate a venue, such as the international court in The Hague, where conflicts between BITS, FTAS and other regional and multi-lateral treaties can be resolved.

Summary of Research

In our research, development and environmental economists from the United States, Mexico, Brazil, Argentina, Chile, and Costa Rica wrote the report based on original research from across the region. In case studies on Argentina, Brazil, Bolivia, Chile, Costa Rica, Ecuador, Mexico, Uruguay, and Venezuela. The Working Group examined how foreign investment during the reform period has affected economic growth, environmental policy and performance, and the countries' political economies.

Beginning in the early 1990s, nations in the Americas began to liberalize their regimes for foreign investment. Pursued unilaterally or BITS or PTAs, a typical set of reforms included the elimination of performance requirements such as requirements to source from domestic firms or to export a certain percentage of production, restrictions on the ability to exclude certain sectors from FDI and to "screen" foreign investment for development goals, restrictions on the ability to require joint ventures or research and development facilities, and so forth. Moreover, such reforms alter the nature of settling disputes over foreign investment. Whereas trade agreements have traditionally relied on states to settle disputes among themselves in international fora, newer trade and investor agreements have "investor-state" dispute systems where foreign firms can directly sue a national or local government without host government oversight.

These policies were advocated by the U.S. government, the World Bank, and the International Monetary Fund and endorsed enthusiastically by many governments across the Americas. They have become enshrined in the 1994 North American Free Trade Agreement (NAFTA) between the U.S., Canada and Mexico, which became the template for subsequent regional and bilateral accords, including agreements on the U.S.-Chile Free Trade Agreement, the U.S.-Dominican Republic-Central America Free Trade Agreement (CAFTA), the U.S.-Peru Free Trade Agreement and countless numbers of Bilateral Investment Treaties (BITS). Investment liberalization of course, has been part of a larger effort broadly referred to as the Washington Consensus. The broader reforms include a package of economic policies that promote economic development by opening national economies to global market forces. Over the last twenty years, governments throughout Latin America have reduced tariffs and subsidies, eliminated barriers to foreign investment, restored fiscal discipline by reducing government spending, and have generally reduced the role of the state in all aspects of the economy.

The promise, among others, of following these policies is that FDI by multinational corporations will flow to developing countries and be a source of dynamic growth. Beyond boosting income and employment, the hope was that manufacturing FDI would bring knowledge spillovers that would build the skill and technological capacities of local firms, catalyzing broad-based economic growth; and environmental spillovers that would mitigate the domestic ecological impacts of industrial transformation.

These policies and agreements have raised concerns, in part because they have shown poor results. Economic growth in per capita terms in the region was slower than in the last decades of the import substitution period-–– less than 2% since 1990, the period of the reforms,. A major finding of our work is that slow growth is in part explained by the fact that FDI failed to lead to more total investment into Latin American economies.

Among our main findings are:

1. FDI was concentrated in a small handful of countries in the region. Brazil, Mexico, Argentina, Chile and Venezuela received more than 80 percent of all the FDI in the region;
2. Foreign firms by-and-large located in Mexico and the Caribbean tend to serve as export platforms to the United States, whereas those that located in South America tend to sell to domestic markets in that region.
3. FDI was attracted by traditional determinants, not necessarily whether a nation has a regional or bilateral trade and/or investment treaty or if it can serve as a pollution haven for foreign firms;
4. When FDI did come, foreign firms tend to have higher levels of productivity and higher wages and generally increase trade in the region; yet

5. FDI fell far short of generating “spillovers” and backward linkages that help countries develop, and in many cases wiped out locally competing firms thereby “crowding out” domestic investment.
6. The environmental performance of foreign firms was mixed, sometimes leading to upgrading of environmental performance, and in others performing the same or worse than domestic counterparts.

Working Group studies documented and analyzed the track record in specific countries and sectors as well:

- In Brazil, Argentina, Mexico—three countries that have received the lion’s share of FDI in the region--and Costa Rica it found that:
    - Foreign firms have higher wages, productivity, and trade *vis a vis* domestic firms
    - However, linkages with national firms and the domestic economy in general are weak, specially in Mexico and Costa Rica
    - Although foreign firms may bring the technologies generated in their headquarters, they do not contribute to an increase in R&D expenditures in the host economies

- In Brazil, Mexico, Chile, and Argentina
    - Virtually all foreign firms transferred environmental management systems to host countries; however
    - It is not clear that such firms were actually in compliance with host country laws and in Brazil there is little indication that foreign firms were more likely to be in compliance than domestic firms were;
    - There it little evidence that foreign firms are greening their supply chains (given that so many supply chains were wiped out from FDI); and
    - In some instances such as the forestry sector in Chile, foreign firms that exported through fair trade certification schemes were “upgrading” to higher levels of environmental standards;
    - In others, such in Mexico’s electronics sector, foreign firms were not exporting to meet strong standards in Europe given that their chief export market, the United States, does not have such standards.

- In Venezuela, Bolivia, Ecuador, and Uruguay
    - A Uruguayan BIT constrained the set of policies available to solve a conflict over foreign investment and transboundary environmental problems with Argentina; whereas
    - BITs in Bolivia, Ecuador, and Venezuela were refused by governments that were able to renegotiate the terms of contracts with foreign hydrocarbon firms.

New Directions for FDI and Sustainable Development

The Working Group found–in agreement with the broader literature on the subject- that investment regime liberalization-led FDI has had at best a limited success in Latin American countries.

Hence, it comes as no surprise to find that virtually all newly elected governments in Latin America, and now your committee, are rethinking the role of FDI in their economies. While some countries are just beginning to debate the issue, others are going so far as to nationalize foreign firms. Yet, most governments are looking for a more balanced approach. What our research makes clear is that new policies are needed. Based on the research abovementioned, three broader lessons can be drawn out as principles for policy-making in this field:

1. **FDI is not an ends but a means to sustainable development. Simply attracting FDI is not enough to generate economic growth in an environmentally sustainable manner.** The report shows that even in the nations that received the lion's share of FDI in the region—Brazil, Argentina, and Mexico—FDI fell short of generating spillovers and sustained economic growth. FDI needs to be part of a comprehensive development strategy aimed at raising the standards of living of the nation's population with minimal damage to the environment.

2. **FDI policy needs to be paired with significant and targeted domestic policies that upgrade the capabilities of national firms and provide a benchmark of environmental protection.** There are numerous country- specific policies that are either being implemented or debated regarding ways in which Latin American nations can overcome information and coordination externalities, access to credit problems, and competitiveness issues on the part of their domestic firms. In this regard, lessons from Asia may be drawn, since many nations in that region have put in place targeted industrial policies to link domestic firms to foreign firms to enable domestic firms to develop into competitive exporters themselves.

3. **International agreements, whether at the World Trade Organization (WTO) or at the level of BITS and PTAs need to leave developing nations the "policy space" to pursue the domestic policies necessary to foster sustainable development through FDI.** The emerging international regime of international investment rules is restricting the ability of developing nations to pursue some of the policy instruments that have been successful at channeling FDI for development in Asia and elsewhere. When acting collectively under the auspices of the WTO developing nations have largely succeeded in blocking proposals that would further restrict such policy space. However, slower movement in global trade talks has led to a proliferation of BITS and PTAs between developed and developing countries where developing countries have much less bargaining power and end up exchanging policy space for market access.

Final Remarks

I would like to thank and congratulate the Chairman and the Subcommittee for holding this hearing today. In the wake of the current financial crisis it is both timely and important to review the elements of investment obligations in U.S. trade and investment agreements. The 2004 model US BIT outlaws measures such as capital controls, performance requirements, and technological transfer—all measures that the economics profession endorses and that the US is advocating that nations across the world deploy and that we ourselves are conducting at home.

Your hearings are an important first step in a more comprehensive review of U.S. trade and investment policy. I look forward to your questions, and to constructively working with you on these issues into the future.