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Priorities Behind the Border

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Trade

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Priorities Behind the Border

Restrictions on tax and incentive competition to attract investors

One arena in which an international agreement might be of immense benefit to developing countries concerns their competition for investment through concessionary tax rates and financial subsidies. The main beneficiary of that competition is international business and often countries suffer large fiscal losses without commensurate gains to either their domestic economy or to the efficiency of the location of international production.[1] If authorities were to embark on cross-country (or cross-jurisdiction) policy action, there are essentially three options, representing three levels of ambition with regards to the objectives being pursued. In ascending order these are: (1) transparency-enhancing obligations on firms and countries;[2] (2) co-operation between jurisdictions;[3] and (3) the putting in place of enforceable international rules.[4]

[1] For a discussion of harmful tax practices see OECD (1998). For welfare losses from international tax competition see Charlton (2003).

[2] See Oman (2000).

[3] OECD countries adopted a similar approach in their efforts to identify and reduce 'harmful tax competition' (OECD 1998). While the OECD's mandate here covers mainly general tax rates rather than specific incentives, the criteria used to determine 'harmful' tax policies is instructive for investment incentives. Two of the criteria cover transparency and discrimination between foreign and domestic firms. The European Commission's 1999 'Code of Conduct (Business Taxation)' has taken a similar approach.

[4] Three alternative frameworks could regulate incentives with reference to (1) size (capping the total financial benefit available); (2) use (e.g. specifying geographical areas or sectors in which they are allowed/prohibited); or (3) instrument (proscribing instruments perceived to be particularly harmful).

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Just as international agreements circumscribe subsidies in general, there should be a strong proscription on firm-specific competition. The spirit of the WTO's Agreement on Subsidies and Countervailing Measures (SCM) could be extended to new rules limiting investment competition. Under the SCM, subsidies are actionable if they can be shown to cause adverse trade effects. One of the adverse effects triggering actionability under Part III is 'serious prejudice to the interests of another member'—a principle which could be analogously applied to the incentive instruments used in investment competition.

The European Union (which has been operating state aid guidelines now for several decades) provides an example of how rules might be developed. Although grants and subsidies to foreign direct investors are not explicitly targeted by Commission policy, in practice they are one of the main forms of state aid regulated by it. The definition of state aid clearly encompasses traditional instruments of investment attraction. Indeed the European Commission classifies state aid as including (1) grants to firms; (2) loans and guarantees; (3) tax exemptions; and (4) infrastructure projects benefiting identifiable end-users. These payments are regulated by the European Commission, which claims some success in reducing subsidies in the EU.[5]

Anti-corruption policies

While trade in general may benefit developing countries, some kinds of cross-border transactions clearly harm them. One particularly insidious interaction between foreign firms and developing countries is rampant corruption: it is often less expensive to bribe government officials to obtain, say, a concession than to pay the full market price. International non-bribery legislation (such as America's

[5] See Charlton (2003) for a discussion of the EU's state aid regulations as applied to foreign investment incentives.

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Foreign Corrupt Practices Act) should be made part of an international agreement. There should be full disclosure of all payments made to foreign companies (publish where you pay). There should be an agreement that only disclosed payments will be tax-deductible; but even stronger enforcement measures should be undertaken. There should also be a commitment to repatriate funds stolen or otherwise illegally obtained (e.g. through corrupt transactions) from developing countries. And transactions giving rise to other sources of illicit revenues, particularly those which support armed insurrection, such as 'conflict diamonds', should be proscribed.

Secret bank accounts facilitate corruption, by providing a safe haven for funds stolen from a country. This adversely affects developing countries to a significant degree. There should be an international agreement proscribing bank secrecy (the importance of which has recently been recognized in the case of terrorism). This too can easily be enforced. No bank should be allowed to deal with any bank in a country which does not conform to agreed transparency standards. It should be possible to sue any country that does not enforce such a sanction (e.g. under provisions similar to those discussed above under fair competition).

Finally, as we have noted, arms sales have had a devastating effect on many of the poorest of the developing countries. The developed countries are the major source of these arms. Developed countries must make a commitment to restrict these sales.

Anti-civil-strife policies and pro-environment policies

Trade agreements have largely been designed to *expand* the scope of trade, on the premise that trade is beneficial. Trade policy has become controversial because there are some notable instances where that does not seem to be the case. The most obvious are trading in arms, especially small arms, trafficking in diamonds and other minerals which help finance the purchase of arms, and the narcotics trade.

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It has become well accepted that countries that export drugs have a responsibility for containing the sale of those drugs. This perspective has been pushed by the advanced industrial countries; as they have come to recognize their inability to control consumption and the demand side, they have put increasing responsibility on the supply side. The same principle should hold for arms trade—it may be far easier to control the sale of arms than the purchase.

The recent trade dispute known as the Shrimp–Turtle case[6] raised concerns about the WTO's role in sustainable development issues. This dispute arose over US restrictions on imports of shrimps from countries that did not have conservation programs for migratory turtles. Each year, thousands of sea turtles are killed in shrimp trawl nets. To protect these endangered animals, the US passed a law to prohibit the import of shrimp from nations which do not require shrimp boats to be equipped with 'turtle-excluder devices' (TEDs)—attachments that enable turtles to exit unharmed from nets. The US measure was challenged at the WTO by India, Malaysia, Pakistan, and Thailand. These countries argued that the law was an illegal restriction on their shrimp exports and thus contravened WTO obligations. In response, the United States argued that their measure was covered by Art. XX of the GATT, exempting WTO members from their trade obligations in order to protect human, animal, and plant life (Art. XX(b)) or conserve natural resources (Art. XX(g)) when deemed necessary. In its adjudication, the WTO's Appellate Body made clear that the WTO gives countries the right to take trade action to protect the environment, in particular relating to human health, endangered species, and exhaustible resources. It argued that the preamble to the WTO recognized the goal of sustainable development as an objective of the organization and this made environmental protection a legitimate and important goal of policy, ranking with protection of international trade as a WTO objective. The Appellate Body also said that measures to protect sea turtles would be legitimate under GATT Art. XX,[7] which

[6] Appellate Body Report WT/DS58/AB/R, adopted 6 Nov. 1998; original panel report WT/DS58/R and Corr. 1, as modified by the Appellate Body Report WT/DS58/AB/R.

[7] Article XX provides specific instances in which countries may be excepted from WTO rules. These include two sets of circumstances for environmental protection.

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provides exceptions to the WTO's trade rules so long as certain basic criteria such as non-discrimination are met. The US lost the case, not because it sought to protect the environment but because it discriminated between WTO members. (The United States was discriminating by giving Asian countries only four months to comply with its law, but allowing Caribbean Basin nations three years.) But the significance of the Shrimp–Turtle rulings is that they endorse the use of trade policy to enforce environmental standards. There is of course a danger here that the economically powerful nations, principally the US and the EU, but soon probably China, will be able to impose their political will upon countries which are economically dependent on uninterrupted access to these metropolitan markets. But the WTO's law is evolving in a responsible way which defers to multilateral attempts to deal with global environmental problems.

Several environmental treaties already enshrine the right to use trade policy to enforce the agreement.[8] Where two countries are party to an environmental agreement the WTO should enable countries to use trade policy to enforce it, consistent with the agreement. Where there is a multilateral environmental agreement and a signatory country attempts to take action affecting the trade of a country that has not signed and is not in compliance, the WTO should also enable this if the treaty is genuinely multilateral (as in the case of the Kyoto Protocol). Countries that have signed multilateral agreements to deal cooperatively with global problems should be able to apply the agreement even to goods and services from countries that have not. Certainly restrictions on environmentally unsound techniques of production can have adverse effects on particular developing countries. The discussion above suggests that nonetheless there may be a compelling case for such restrictions. This is especially true for global warming, which may itself have a particularly adverse effect on some

[8] There are more than 200 multilateral environmental agreements. About 20 of these include provisions that can affect trade: for example they ban trade in certain products, or allow countries to restrict trade in certain circumstances. Among them are the Montreal Protocol for the protection of the ozone layer, the Basel Convention on the trade or transportation of hazardous waste across international borders, and the Convention on International Trade in Endangered Species (CITES).

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developing countries, like Bangladesh and many of the countries in the tropics.

Responding to crises: from beggar-my-neighbor to help-my-neighbor

In the event of a crisis afflicting one member the WTO should encourage *other* countries to take special measures to assist it. Crises can restrict the availability of short-term trade finance and hence dramatically reduce trade. Trade finance is particularly important in developing countries where exporters may have limited access to working capital and will often require financing to undertake production before receiving payment. At its Fifth Ministerial Meeting in Cancún the General Council of the WTO presented a report to Ministers stating that, 'Based mainly on experience gained in Asia and elsewhere, there is a need to improve the stability and security of sources of trade finance, especially to help deal with periods of financial crisis' (WTO Document WT/WGTDF/2).

Already public institutions, including regional development banks, have had success in making trade financing and guarantees available to emerging economies. Trade finance facilities provided by regional banks to importers and exporters can include the provision of working capital loans or overdrafts, issuing-performance, bid, and advance payment bonds, and extending letters of credit (see Stephens 1998). For example, in 2000 the Asian Development Bank made available a $150 million Political Risk Guarantee Facility to international banks confirming Pakistani letters of credit. The facility provided open access to any international bank, covering only political risks, while leaving commercial risks to the banks. In 1998 the Export–Import Bank of the United States provided short-term insurance for more than $1 billion of US export sales to South Korea (see Auboin and Meier-Ewert 2003).

Many types of export assistance, including export credit insurance schemes, are subject to binding rules under SCM. The SCM prohibits

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subsidies that are contingent upon export performance—and export credits, guarantees, and insurance may under certain circumstances fall within the scope of that prohibition. Under Article 1 of the SCM, a subsidy is defined as (*a*) a financial contribution (*b*) by a government or public body within the territory of a member (*c*) which confers a benefit. The principles of the SCM might contradict trade finance assistance because export credit, guarantee, and insurance schemes involve 'financial contributions', and central banks, export credit agencies, and other government-owned or controlled entities that provide such schemes likely constitute 'governments'. Thus as well as working to develop multilateral mechanisms to improve trade finance during periods of crisis, the WTO must ensure that the SCM does not restrict this kind of assistance (at appropriate interest rates) during periods of crisis by governments or regional development banks.

Since trade will ultimately be the route through which countries in crisis achieve a balance-of-payments recovery, the WTO should encourage members to assist countries in crisis by undertaking special measures to open up their markets. For instance, in the Argentine crisis, if countries had provided special access to Argentinian beef or wine, it might have modulated the downturn and facilitated a quicker restoration of the economy. An international panel within the WTO should assess whether a crisis exists which might benefit from special trade-opening measures, and how those 'help thy neighbor' policies might be implemented.

One of the original motivations for international trade agreements was the fear of the kinds of beggar-thy-neighbor policies which marked the Great Depression. Nonetheless, even within the WTO, there are provisions (almost never invoked) that allow countries to take emergency measures. The issue is important because given the unstable global financial and economic system, country after country has faced a crisis in recent years. By one reckoning there have been a hundred crises in the last three decades. Rather than resorting to beggar-thy-neighbor policies, encouraging countries to return to protectionist measures in the event of a crisis, it would be far better to encourage *other* countries to take special measures to open up their markets.

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Trade implementation and environment facility

The developing countries are at a marked disadvantage, not only in negotiating fair trade agreements, but also in implementation. We noted one aspect of this earlier: their difficulty in mounting challenges to bio-piracy actions under TRIPS Agreement.

Some developed and many less developed countries give substantial subsidies to energy consumption, which has adverse effects on the global environment. The costs of global warming are likely to be particularly severe for some developing countries, such as Bangladesh.[9] The international community has recognized the need to assist developing countries to face the incremental costs associated with implementing environmentally sound technologies, which should include adjustment assistance to help developing countries bear the costs of eliminating subsidies to (fossil fuel) energy.

[9] United Nations Environment Programme (UNEP) estimates that the costs of global warming may exceed $300bn annually. These costs stem from more frequent natural disasters, loss of land as a result of rising sea levels, and damage to fishing stocks, agriculture, and water supplies. In some low-lying states such as the Maldives, the Marshall Islands, and the Federated States of Micronesia, losses linked to climate change could exceed 10% of GDP by 2050. (UNEP 2001).