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International Investment Agreements and Services Markets: Locking in Market Failure?

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Summary. — Bilateral investment treaties (BITs) and investment chapters in preferential trade agreements have become popular measures to guarantee investor-friendly policies. While they reassure multinational firms, they also constrain host country authorities in regulating markets to stimulate competition. These problems are widespread in service industries characterized by significant economies of scale. This paper presents case studies of the difficulties the Chilean regulatory authorities faced in regulating the financial services, telecom, and energy industries. It concludes that able regulators are necessary, but that international agreements need to also leave enough policy space.

Key words — services trade, bilateral investment treaties, preferential trade agreements, Chile, foreign direct investment

1. INTRODUCTION

Services trade and investment have become one of the most important driving forces of economic globalization. During 1974–2004, commerce in services grew from 5% to 20% of global trade and from a quarter to over 60% of the total stock of foreign direct investment (FDI) (UNCTAD, 2004a; World Trade Organization, 2004). A growing share of these transactions is covered by preferential trade agreements (PTAs), accords that reduce barriers to trade and investment between members only. A recent survey by the WTO concludes that PTAs in services are multiplying faster than any other type of trade agreement (Crawford & Fiorentino, 2005). By contrast, the General Agreement on Trade in Services (GATS) plays only a minor role for services FDI in developing countries (Hoekman, 1995, p. 113; Sauvé, 2000). Remarkably, preferential trade and investment in services remains primarily a North–South affair. Services transactions between the major economic powers EU, USA, and Japan are covered by commitments made in the WTO and the OECD. Developing countries at times include services in South–South PTAs, but with few exceptions like South Korea, Brazil, and Mexico they are still insignificant foreign investors in the sector (Ramamurti, 2001, p. 27).

A second instrument of growing importance is *bilateral investment treaties* (BITs) (Vandevelde, 1998). BITs are international legal commitments that guarantee the property rights of foreign investors. BITs and PTAs increasingly converge, as preferential agreements include BIT-equivalent chapters, while BITs negotiated by the United States prescribe the granting of pre-establishment rights and concrete steps toward the liberalization of investment rules that also apply to services. All PTAs negotiated by the United States, Canada, and Japan with developing countries include BIT-like chapters with investor-state dispute-settlement procedures, while

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European countries are in the process of "upgrading" their existing BITs through renegotiations.

Although PTAs and BITs are not the most important measures to *reduce* trade and investment barriers, since most countries undertake these steps unilaterally, they have become the principal international contracts to *maintain* open FDI regimes for services in developing countries. Current research suggests that international agreements help countries attract FDI by signaling that they will pursue a liberal economic policy (Neumayer & Spess, 2005). This benefit, however, comes with a price: by promising an investor-friendly policy, developing countries limit their regulatory freedom. This paper argues that because many services industries require regulation to guard against market failure, the trade-off implied by international agreements can prevent host countries from reaping the full benefits of liberalization. Rather than reducing prices for consumers, they can lead to transfers of rents to foreign firms, or the replacement of domestic oligopolists by foreign ones. Intended as a protective measure against expropriation, BITs and investment chapters in preferential trade agreements may have the effect of deterring host countries from regulating effectively to ensure competition.

Many service industries are textbook examples of imperfect competition. If such industries are opened to foreign investment, first-movers can buy up enough assets, achieve a dominant market share, and deter competitors from entry (Tirole, 1988). Even if liberalization is later "multilateralized," or applied on a non-preferential basis, first-movers may not have to face real competition.

This article presents case studies of services liberalization in Chile to provide evidence of the constraining effect of market structures and international agreements. The Latin American country is a good test case because it is relatively small, with a population of about 16 million and a per-capita income of about US$5000 at market prices, [2] and had already undertaken significant steps to liberalize its service markets prior to signing any PTAs or BITs. Moreover, since successive Chilean governments have pursued liberalization more vigorously than most developing countries, many service industries are almost completely foreign-owned. Protection of domestic industries therefore cannot account for the lack of competition.

This paper focuses on three industries in which foreign investment is often a precondition for market entry: energy, telecommunications, and financial services. The analysis first shows how in the first two industries companies used open threats to try to constrain regulators, while in banking government officials worried about international legal constraints despite their conviction that the existing rules were insufficient. It then provides evidence that foreign firms directly sought constraints on host country governments in PTA negotiations when it suited their competitive position (as in the case of the EU-Chile FTA), while firms that were excluded raised market-opening demands that may stimulate competition (as in the US-Chile FTA).

This paper proceeds as follows. The first section briefly surveys the literature on preferential trade agreements, BITs, and the protection of FDI. Section 2 spells out the theoretical case for why market structures in services require strong regulation. Sections 3 to five turn to the case studies. The final section concludes and considers policy implications.

2. SERVICES FDI, COMMITMENTS, AND SIGNALING

Developing countries have to deal with two fundamental challenges when trying to attract FDI. First, they need to reassure foreign investors that their property rights will be respected by future governments that may have different policy preferences—a time-inconsistency problem that requires a credible commitment. Second, they need to distinguish themselves from other potential FDI hosts by showing their true intentions to investors with a limited capacity to assess risks—a problem of incomplete information that calls for a costly signal.

In the theoretical literature, the first point has most commonly been used to explain why developing countries sign trade and investment agreements with developed partners. Ethier (1998, 2001) emphasized that developing countries are not primarily trying to extract major tariff concessions from their developed negotiating partners when pursuing PTAs. Rather, they are competing to attract FDI, a key objective of liberalization and economic reform (Shadlen, 2005). Other authors underscore this point. Fernández and Portes (1998) argued that PTAs lock in a policy of reform and economic liberalization. These "non-traditional gains"