Investing for Growth

Spurring Infrastructure Development and Economic Growth Through Foreign Direct Investment

Prepared for the National Center for APEC and APEC Business Advisory Council

Preface

I'm honoured to have the opportunity to say a few words about this important publication. I've been involved in APEC since its inception as part of the "Hawke Initiative" in 1989. Since then, APEC has done much to drive trade and investment liberalisation across the Asia-Pacific region, and it has been encouraging to see how much we have achieved in that time.

But we can and must do better. Our 21 economies contain almost half the world's consumers, and account for around 43 percent of world trade. We need to step up efforts to develop better and more transparent investment rules, and to foster broader, deeper, APEC-wide integration of these open policies.

Investment has its most positive and efficient impact on growth and development when it is able to flow freely across borders, unimpeded by regulatory or other barriers. Quality investment seeks out quality regulatory environments: in 2008, the thirteen APEC economies with the most permissive investment environments took in 30 percent of global FDI inflows. Those same economies' total FDI inflows more than quadrupled between 1996 and 2008; with the rate of growth in their FDI outflows not far behind.

The barriers that prevent and prohibit investment can be complex and wide-ranging. They create stumbling blocks at and behind the border, and create unnecessary risk and uncertainty for investors, chilling foreign and domestic investment, and in turn inhibiting economic growth throughout the region.

APEC has long been a proponent of open trade and investment policies, and it operates as an effective vehicle to build the confidence and capacity to get those policies adopted. As the region's pre-eminent forum for trade and economic policy, APEC is an ideal environment for innovative thinking on eliminating investment barriers, improving business regulation, and enhancing connectivity between the private sector and government to entrench a pro-growth investment climate in the region.

This publication is a bold step towards that goal. It is a challenge to our economies to take seriously the opportunities presented by investment in the region. It is a call to action to build and promote a better investment environment in APEC – not just to generate domestic and regional growth – but to set an example of what is possible on a global scale. At a time of financial and economic uncertainty, we simply cannot afford to ignore that imperative.

Rt Hon Mike Moore
Ambassador of New Zealand
to the United States of America

Executive Summary

Based both on recommendations from the APEC Business Advisory Council (ABAC) and of its own initiative, APEC has engaged in extensive work on investment, infrastructure, connectivity and transparency, among other issues, which has contributed to improvements throughout the APEC region. At its meeting in Seoul in April 2011 ABAC proposed that a publication should be developed for the information of interested parties. This is that publication.

The economic growth and development experienced throughout the Asia Pacific over the last quarter century have been phenomenal, but the challenges ahead remain vast. The APEC economies' economic growth – driven in significant part by the region's opening to foreign direct investment – FDI – has contributed importantly to poverty alleviation, increased employment levels, and greater economic activity and stability.

Despite this progress, increasing FDI inflows have never been more vital for the APEC economies. With burgeoning populations, concomitant infrastructure demands and tight fiscal budgets, many APEC economies need to reposition themselves to become again a top destination for FDI inflows within the next decade. Failure to achieve this objective could put at risk the major economic gains and poverty reduction that the region has experienced over the last quarter century.

While long a top destination for FDI, APEC's share of world FDI has declined since the 1990s. Though the APEC economies have been able to recover more quickly from the economic downturn and their progress in opening markets and adopting important economic reforms continues, barriers to attracting greater FDI remain, including barriers to market entry and barriers created by operational environments that include counterproductive, discriminatory, inconsistent or unstable economic policies; weak institutions; infrastructure gaps and other factors.

To meet successfully the economic, infrastructure and other challenges of the 21st century, APEC economies need to enhance their investment competitiveness in order to attract even greater long-term and growth-producing FDI in the years and decades ahead. Key areas of work include (1) identifying and eliminating the key barriers to productive FDI; (2) adopting and promoting whole-of-government approaches to economic policy that create predictable, open, and growth-oriented investment climates with strong institutions that can enable further progress; (3) developing the necessary capability and capacity to encourage strong infrastructure investment through Public Private Partnership – PPP – programs; and (4) increasing emphasis on robust and comprehensive International Investment Agreements – IIAs.

In addition to recommendations developed through its working groups, ABAC's Advisory Group on APEC Financial System Capacity-Building has engaged with experts to increase its expertise and has undertaken or sponsored capacity-building initiatives. In 2010 the Advisory Group started developing the Asia-Pacific Infrastructure Partnership (APIP). APIP comprises a pool of persons from the private sector who are actively involved with infrastructure projects as investors, advisers, contractors, etc. In dialogue, convened and facilitated by the Advisory Group, they join with high level officials from a member economy to explore and seek to devise solutions for the specific needs and priorities of that economy. The first of these dialogues has been with Peru and Mexico at the fringes of ABAC's August meeting in Lima.

To address the urgency of current needs, APEC needs to act quickly to build upon this extensive work and advance a heightened agenda to promote FDI growth throughout the region, with a particular focus on infrastructure. Key activities that APEC should undertake include:

- Reaffirmation and reinvigoration of the Investment Facilitation Action Plan to identify critical barriers to greater FDI inflows, key priorities for action and the development of a work program to aid in Individual Investment Action Plans, with regularized private sector input.
- Review of the initial progress of the Pilot PPP Mentoring Scheme adopted by the APEC Finance Ministers in November 2010, the development of a PPP Action Plan to continue the PPP Mentoring Scheme and undertake additional capacity and work over the next three years, including through work with multilateral organizations to develop critical reforms and identify PPP pilot projects.
- APEC-wide reaffirmation of the importance of moving quickly to adopt as a region common and high-standard core investment disciplines to enhance the ability of APEC economies to attract vitally needed FDI and the inclusion of such investment disciplines, including non-discrimination, core protections and investor-state dispute settlement, in a high quality, comprehensive Free Trade Area of the Asia Pacific (FTAAP) and in pathways to FTAAP, potentially including the negotiation of an APEC-wide International Investment Agreement (IIA).

Introduction: FDI Growth and Challenges in the Asia Pacific

By Sri Mulyani Indrawati, Managing Director, The World Bank

The dramatic economic growth of Asia Pacific over the past generation owes much to the region's opening up to FDI. For the economies in the region, this growth has contributed to poverty alleviation, increased employment levels, macro stability and healthier and stronger balance sheets.

Inward FDI into the APEC economies rebounded significantly in 2010 with the region's share of global FDI inflows more than doubling in the last five years, reaching a total of $8.5 trillion in inward FDI stocks and $620 billion in inward FDI flows in 2010. APEC economies accounted for 44 percent of the value of greenfield investments in 2010, up from 38 percent just five years ago. While there is a substantial disparity in FDI inflows and inward stocks among the individual APEC economies, 19 of the 21 APEC economies have doubled or more than doubled FDI inward stock in the last 15 years alone.

FDI INWARD STOCK BY APEC ECONOMY
(US$ millions)

	1995	2000	2010	% Change 1995-2010
Australia	104,074	118,858	508,123	388%
Brunei Darussalam	643	3,868	11,225	1646%
Canada	123,181	212,716	561,111	356%
Chile	24,437	45,753	139,538	471%
China	101,098	193,348	578,818	473%
Hong Kong, China	227,532	455,469	1,097,620	382%
Indonesia	20,698	25,132	121,527	487%
Japan	33,531	50,322	214,880	541%
Korea, Republic of	9,497	38,110	127,047	1238%
Malaysia	28,731	52,747	101,339	253%
Mexico	41,130	97,170	327,249	696%
New Zealand	25,728	24,894	70,129	173%
Papua New Guinea	1,667	2,010	1,745	5%
Peru	5,510	11,062	41,849	659%
Philippines	10,148	18,156	24,893	145%
Russian Federation	5,601	32,204	423,150	7455%
Chinese Taipei	15,736	19,521	64,288	309%
Singapore	65,644	110,570	469,871	616%
Thailand	17,684	29,915	127,257	620%
United States	1,005,726	2,783,235	3,451,405	243%
Viet Nam	7,150	20,596	65,628	818%
TOTAL	1,875,147	4,345,657	8,528,692	355%

Source: UNCTADstat

Notably, FDI inflows to developing East Asia and the Pacific in particular rose from around $200 million to $180 billion between 1970 and 2008, a growth of 20 percent annually, before the recent economic crisis. Since the crisis, FDI inflows into the APEC economies have rebounded more quickly than other parts of the world and APEC region's share of FDI inflows reached 50 percent in 2010, although FDI stocks remains lower than their peak in the late 1990s.

While the influx of FDI helped to modernize the region's industrial base, complementary domestic investment in trade and social infrastructure was and remains critical to enable economies to take full advantage of the dynamic potential of trade and investment for building competitiveness. During this same time, gross domestic investment increased from 25 percent to between 35 percent and 40 percent of GDP, while other developing regions of the world languished between 15 percent and 25 percent. The result has been the emergence of dynamic and deeply integrated regional production and trade networks – more than 50 percent of trade is intra-regional – which will continue to drive growth in the region in the future.

An important recent development is the emergence of new sources of investment from *within* the region. Take China, for example – its non-financial outward FDI rose from $2.7 billion in 2002 to $68 billion in 2010, but this still amounts to less than 1 percent of GDP, with very little of it coming in manufacturing and services sectors. As firms and investors from China and throughout the region look increasingly outwards, the potential for expanded FDI, further regional economic integration, and robust growth, will be immense.

As the APEC economies move to restore and expand economic growth, they face several major and inter-related challenges. Risks remain from the potential of slowed growth and from possible overheating, increased short-term capital inflows and asset bubbles. Rising inequality within economies also raises potential challenges that will need to be addressed. And finally, given the need to continue with the second generation of reforms and not stagnate, economies that have already advanced to middle income status must continue the process of structural transformation and avoid the"middle income trap". On top of these challenges, the region will need the resilience to deal with the impact of global issues, the lingering financial crisis, and vast infrastructure needs as populations continue to rise.

The infrastructure needs of the Asia-Pacific region are a pressing and growing issue. The Asian Development Bank (ADB) in its report *Infrastructure for a Seamless Asia* estimates that the region must spend $8 trillion over the next 10 years on critical energy, transport and communications infrastructure. Rapid growth in the region has opened up the infrastructure gap, creating bottlenecks that constrain economic growth. These gaps threaten the sustainability of economic growth, continued development and poverty reduction, as well as the ability of these economies to continue to attract FDI.

Despite tremendous progress made within the region on trade and financial integration in recent decades, cooperation on investment liberalization lags. Overall, the region remains one of the most restrictive in the world for foreign investment. This lack of openness to FDI is particularly noticeable in critical backbone services, like

energy, transport, and telecommunications, where foreign ownership is seriously restricted, often below 50 percent, in most economies in East Asia. Yet, these are precisely the sectors where major new capital inflows are required to develop, update and expand critical infrastructure networks.

Lower income economies in the region face the need to improve competitiveness to break into regional and global production networks in order to exploit opportunities for investment, job creation, and access to technology. While there is no single solution to this challenge, one opportunity is for increased investment in regional infrastructure networks (e.g. road and rail) to allow these economies greater physical connectivity to existing regional production networks. Middle income economies seeking to move to high income economies need to invest further on higher education and promote an environment of innovation, in addition to their traditional focus on finance and infrastructure development.

As discussed in the sections that follow, the starting points for addressing these challenges will be maintaining a prudent macroeconomic environment and a good, pragmatic macro policy mix. Aligned with these measures will be the need to identify existing barriers to FDI; continuing the reform agenda by focusing on the second generation of reforms, including legal/judicial, institutional civil service and anti-corruption; promoting capacity and capabilities that will draw in greater FDI in infrastructure and promoting stable and consistent international frameworks to advance the region's ability to attract greater investment flows.

Barriers to Growth-producing FDI in the Asia Pacific

Since the 1980s, there has been a large shift in the composition of global private capital flows towards non-debt creating FDI. There is strong empirical evidence that FDI flows are less volatile than other capital flows, and FDI is found to be better for economic growth and development than other capital flows. In particular, FDI plays an important role as a catalyst for economic growth in both developing and developed economies. By expanding available capital, advancing skills and introducing new technologies, FDI stimulates not only economic growth, but also domestic investment. In turn, FDI and domestic investment can promote employment, new products and services and attract new customers. The APEC economies have already experienced many of these benefits over the last quarter century.

For these reasons, most economies, including the APEC economies, have adopted various policies to promote FDI over the years. For the average OECD country, inward FDI stocks amounted to 49 percent of GDP in 2009, up from 14 percent in 1980. Total sales from the foreign affiliates set up through FDI have almost twice the value of world exports, making FDI as important as, if not more important than, international trade. After a year of stagnation in 2010, UNCTAD expects global FDI to rebound by 15 to 30% in 2011.

Notably, 2010 marked the first year when developing and transition economies worldwide attracted more FDI than high-income economies. Such impressive growth in FDI is largely due to the significant progress in reducing numerous barriers to FDI. Some estimate that declining FDI barriers can explain 75 percent of the growth in FDI from 1985 to 2008.

APEC economies have successfully spurred greater growth in FDI inflows and inward stocks over several decades. Yet, APEC's share of world FDI inward stocks peaked at 62 percent in 1999 and has declined thereafter as other regions have enhanced their investment competitiveness and attracted major investment flows and inward stocks. In 2009, APEC economies slowly started to increase their share of world FDI inward stock, reaching 45 percent in 2010, but it remains too early to determine if that upward swing represents a trend or short-term fluctuations.

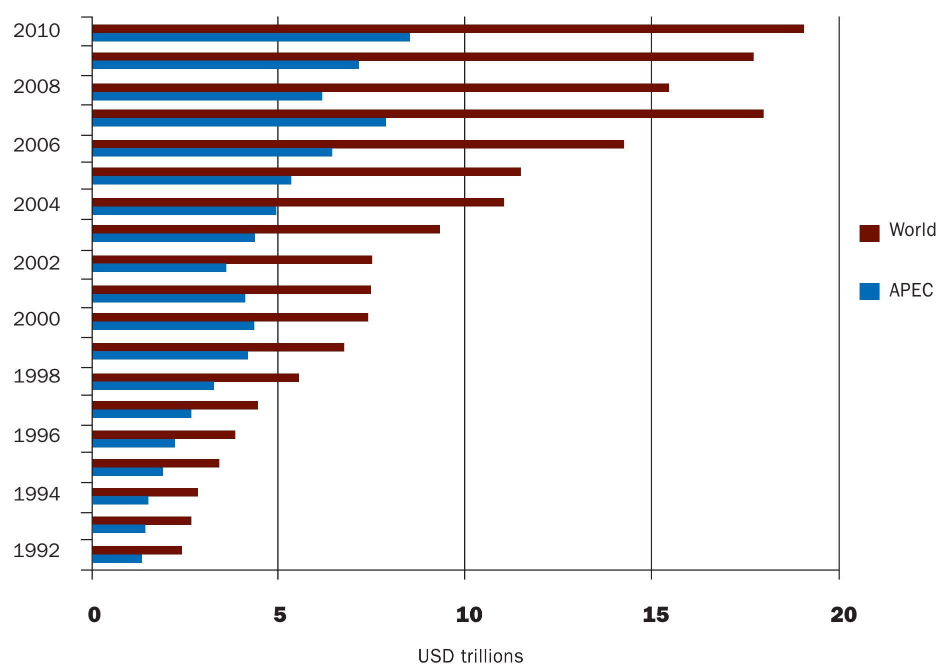
APEC's declining share of inward FDI is particularly concerning given that APEC accounts for some 40 percent of the world's population and its infrastructure and economic needs have grown strongly over the past decade. Therefore, it is imperative for Asia Pacific economies to continue to identify and eliminate major remaining FDI barriers.

While investment barriers can be classified in numerous ways, they generally can be divided into three primary categories: (1) market-entry barriers; (2) barriers in the operational environment; and (3) host economy factor endowment.

Market-entry barriers can exist in the form of entry exclusion for certain industries, oftentimes for perceived strategic and/or security

APEC's Share of World FDI Inward Stocks

(1992-2010)



Source: UNCTADstat

reasons; foreign equity caps; limitations on the type of establishment (subsidiary or branch); joint venture requirements and other personnel issues. For example, only 33 percent of East Asia and Pacific economies permit foreign ownership of land, while the comparable figure is 95 percent for Europe and Central Asian economies and 100 percent for high income OECD economies. Some economies do not allow FDI in such industries as electricity distribution and transmission, rail transport, or banking and insurance. While light manufacturing, tourism and construction sectors are generally open to FDI, many economies impose ownership limits in such service sectors as media, transportation, electricity, and telecommunications. Some economies require the directors or managers of foreign-owned companies to be nationals or permanent residents of the economy of incorporation. Lengthy approval or licensing processes are also another form of entry barrier.

FDI barriers related to an economy's operational environment are even more widespread than entry barriers, especially in developing economies, and their effects are oftentimes as great. As found among the APEC economies, these types of barriers can be identified in numerous areas, including:

- Economic, political and/or social instability that creates uncertainty, increases risk and undermines the attractiveness of potential investment destinations.
- Weak and/or counterproductive economic policies and measures that thwart growth and sustainable business and economic activity. Such policies and measures may include those related to taxation, regulation, international trade, double or duplicative pension obligations, labor issues and property rights. For example, lack of transparent taxation systems and the possibility of double taxation raise particular concerns for foreign investors in the absence of bilateral tax treaties and similar measures.
- Complications, delays and lack of transparency in land acquisition processes. Difficulty in acquiring land for new investments or expansions of existing investments represents a major barrier. Problems encountered in the region include conflicting, unclear and non-transparent regulations in acquiring and titling land and unusually long cycle times for land tendering processes.
- Weak, underdeveloped and/or overly bureaucratic institutions and legal systems. In these cases, institutions are unable to sustain and promote strong and predictable policy outcomes, particularly with respect to the enforcement of contracts and other key property rights, prudential supervision and labor and other matters. Overly burdensome and time-consuming customs processes that limit imports and exports also undermine investment attractiveness, particularly any manufacturing-related investment.
- Corruption and lack of transparency. These issues are oftentimes related to underdeveloped institutions and legal systems.
- Discriminatory policies and measures that seek to mandate certain domestic outcomes, including mandates to use local labor, local inputs, local joint venture partners and local technology. While perhaps well-intended, the best way to promote investment is to attract it, not force it as such forced localization approaches tend to produce the minimum necessary activity, and less of the longer-term, growth-producing investment sought. As well, such measures undermine the ability of governments to obtain the best materials and services at the best prices in highly fiscally constrained times.
- Limited, underdeveloped and/or outdated infrastructure that is unable to serve the population's needs, let alone the demands for expanded trade and commerce. Key infrastructure areas that limit FDI growth include transportation, energy and power, and communications, as well as key services infrastructure, including in the areas of financial markets, accounting, and sanitation.

Notably, each of these FDI barriers also limits the benefits that economies gain from the FDI they are able to attract, representing a burden on the overall domestic economy.

FDI is also affected by the host economy's factor endowment. Foreign investors necessarily consider the factors such as market size, proximity to inputs and markets, per capita GDP, and past and prospective economic performance. While policy makers cannot respond to such factors in the short-to-medium term, if at all, these issues must be identified and considered in formulating appropriate policy measures to promote FDI over the long term.

As documented in the IEG's *Enhancing Investment Liberalisation and Facilitation in the Asia-Pacific Region (Stage 2): Reducing Behind-the-Border Barriers to Investment,* different barriers can have different adverse effects, including unnecessarily increasing costs or complexity, increasing risk and thereby chilling incentives to invest, and/or limiting business competition.

Related to these differing effects, it is also important to recognize that various FDI barriers have varying degrees of impact depending upon the type of FDI being sought. Horizontal FDI are those in search of new foreign markets, while vertical FDI are often pursued as part of global cost minimization. For these types of FDI, any barriers that may lead to higher costs in their foreign operations or difficulty in their operations would be a powerful disincentive to foreign investors. On the other hand, FDI in search of raw materials may have less choice, but oftentimes require greater predictability and risk avoidance given the size, length and complexity of investment to be potentially made.

In sum, while APEC economies have striven to reduce barriers to FDI, many still remain, undermining the FDI competitiveness of individual economies and the region more broadly. To address the challenges of economic growth and infrastructure development in the decade to come, priority action needs to take place to eliminate the most harmful and FDI-chilling barriers throughout the region.

Mechanisms and Policies to Promote Growth – and Infrastructure – Promoting FDI in the Asia Pacific

Addressing barriers to FDI, however, is only one part of the equation. To meet successfully the economic, infrastructure and other challenges of the 21st century, APEC economies need to actively enhance their investment competitiveness in order to attract even greater long-term and growth-producing FDI in the years and decades ahead. While certain factor endowments of individual economies, such as market size, natural resources, or geographical advantages cannot be altered, other characteristics can be changed and, if done so properly, may have highly significant effects on an economy's ability to attract greater and more sustainable FDI flows. Multiple studies and research, including APEC's IFAP, have been focused over the last decade on which domestic conditions and policies are most important to promote stronger FDI growth for individual economies. While not wholly static like geography, some of the key characteristics, such as economic and political stability, education and training of workers, quality and access to infrastructure, and macroeconomic conditions, are ones that require longer-term commitments and planning by governments. Other characteristics can be more easily addressed in the short-to-medium term. Business, international organizations and academics all agree, however, that sustained and serious work on both long-term and medium-to-short-term improvements is critical to create investment climates that continue to attract increasingly sought after long-term FDI.

This section examines three sets of policies and mechanisms on which APEC economies can focus most productively to promote greater growth-and-infrastructure-promoting FDI: (1) developing a strong investment environment through a whole-of-government approach; (2) the criticality of special requirements to attract infrastructure investment, and (3) the relevance of international legal structures to ensure an attractive investment environment going forward.

A. Actions to Develop a Strong APEC Investment Environment to Induce FDI and Economic Growth

While APEC's overall share of global FDI inward stocks has declined in the last decade, individual APEC economies have successfully brought in increasing amounts of FDI, in many cases through intensive investment promotion and facilitation activities, as well as through the reduction of investment barriers discussed previously.

Many of these same APEC economies have shown high levels of per capita FDI and have been recognized by independent organizations for creating economic climates that are open, stable and promote investor confidence, including the following:

- According to the World Bank's *Doing Business 2011,* 14 APEC economies were ranked among the top 50 economies in its evaluation of the overall business climate (including regulations and policies that encourage and hamper investment); most of the remaining APEC economies ranked among the top half of economies globally: Singapore (1), Hong Kong, China (2), New Zealand (3), United States (5), Canada (7), Australia (10), Republic of Korea (16), Japan (18), Thailand (19), Malaysia (21), Chinese Taipei (33), Mexico (35), Peru (36), Chile (43), Vietnam (78), China (79), Papua New Guinea (103), Brunei Darussalam (112), Indonesia (121), Russian Federation (123), Philippines (148). Notably, three APEC economies – Peru, Vietnam and Brunei Darussalam – were cited as among the top 10 economies improving the most in the ease of doing business between 2009 and 2010.
- According to the Heritage Foundation's *Index of Economic Freedom 2010,* eight of the top 20 economies, with leading positions in economic, business and investment freedom and respect for property rights are found in APEC: Hong Kong, China (1), Singapore (2), Australia (3), New Zealand (4), Canada (6), United States (9), Chile (11), and Japan (20).
- According to Transparency International's *2010 Corruption Perceptions Index,* eight of the APEC economies are ranked among the first 25 of the 178 economies included in the study: New Zealand (1), Singapore (1), Canada (6), Australia (8), Hong Kong, China (13), Japan (17), Chile (21), and United States (22).
- Another important indicator is investor confidence. *In Investing in a Rebound: The 2010 A.T. Kearney FDI Confidence Index,* ten APEC economies are ranked among the top 20 economies: China (1), United States (2), Australia (7), Mexico (8), Canada (9), Vietnam (12), Hong Kong, China (14), Russia (18), Indonesia (19) and Malaysia (20).

Chile provides an instructive example, given the sustained and major increases in both FDI flows and FDI stock Chile has experienced for more than a decade. Chile's FDI stock reached $139.5 billion in 2010, the second largest in Latin America after Brazil. In turn, FDI has played a decisive role in Chile's economic development and during the period from 2008 to 2010 averaged 8 percent of Chile's GDP. A substantial part of that investment has been from reinvestment of profits by foreign investors that continue to reinvest given the continued growth that they see. Among the attributes that the Chilean government and foreign investors cite for Chile's success are its consistent government policies across the economy, a predictable legal framework, transparent business environment, low levels of corruption, integrated markets open to the world and important business opportunities, supported by a solid record of political and economic stability. These characteristics are sustained not only in its constitution and laws, but in Chile's government institutions that are essential to ensure that these core policies and conditions are sustained and enhanced. Chile's policies, domestic legal system and institutions are also supported and given greater force through its 39 Bilateral Investment Treaties currently in force and its network of 21 trade agreements with 58 economies allowing

Chilean investors and producers access to a potential market of 4.2 billion consumers that represent 62.5 percent of the world's population and 86.3 percent of global GDP. Chile's approach has been to promote FDI with policies and measures throughout its legal and economic system and in all main sectors of its economy – a whole-of-government approach – that has created a highly investment-friendly environment for FDI.

Other APEC economies, such as Hong Kong, China; Korea, Mexico, New Zealand and Singapore also present important examples of successfully bringing in substantial FDI investment in significant part through each economy's commitments domestically and internationally to openness, transparency, and non-discrimination of foreign investment. Each of these economies has striven to adopt whole-of-government approaches that promote not only core policies across their economies, but also legal systems and institutions to sustain and advance the policies and objectives sought. In all of these cases, these economies have broadly embraced a wide range of measures throughout their governments to promote and facilitate investment and in all of these cases, these economies have been recognized by independent organizations as top performers, further solidifying their investment attractiveness to potential investors.

APEC has taken several important steps towards helping the economies of the region improve their ability to promote and facilitate investment. APEC's *Guide to Investment Regimes of APEC Member Economies* (7th edition) was just published in May 2011 in an effort to provide updated and easily accessible information on the investment regimes of the APEC economies that can help potential investors consider and navigate these markets. The World Bank's *Investing Across Borders – APEC,* prepared at APEC's request, provides an important economy-specific examination of FDI regulation, openness and competitiveness that will help advance APEC's IFAP and investment facilitation throughout the region.

To continue to advance the region's investment competitiveness, several key positive factors warrant additional focus by APEC and the APEC economies, including the importance of:

- Whole-of-government approaches that focus on a broad range of key policies (from transparency and trade to taxation and property rights) across all economic sectors, supported by domestic legal structures and domestic institutions that ensure strong implementation and enhancement of investment promotion and facilitation policies.
- International recognition for progress on key factors, including not only high rankings on many of the international measures identified above, but also through individual economies' adoption of international agreements on core issues such as transparency and non-corruption, taxation, intellectual property protection and investment.
- Open dialogue between the government and private sector, which continues to be a critical element for achieving a favorable climate for investment.

B. Criticality of Infrastructure Development for the Asia Pacific

Meeting the present and future infrastructure needs in the APEC region is a formidable undertaking and will require both government action and private investment, including substantial new FDI. As noted earlier, the APEC economies' infrastructure needs over the next ten years equal about $8 trillion. Making these investments is vital. The International Monetary Fund (IMF) highlights the importance of infrastructure to sustain growth in its report *The G20 Mutual Assessment Process – Alternate Policy Scenarios* (2010), highlighting that a gradual increase in government investment in infrastructure in the emerging Asia region will increase domestic demand in the region and also improve growth in the rest of the world. Around 8 million more jobs could be created in advanced economies and over 21 million in emerging Asia and the rest of the world. According to the companion World Bank Report, *G20 and Global Development* (2010), this could lift 33 million people out of poverty.

Increased and new investment in key infrastructure sectors, such as information and communications technology (ICT), energy, transportation and ports (both air and sea), as well as the quality of services infrastructure, will also support needed upgrades in manufacturing and trading environments and the diversification of product that will promote higher value-added production and services, an area in which the region continues to lag. This will require similar investment in social infrastructure like education, skills, health care, and institutional quality to put economies in the position to host productive investments.

While demand for new infrastructure is growing, there is also rising pressure for funds to replace, operate and maintain existing infrastructure. Competition for funds is intense and fiscal challenges severely limit the amount of public funding available to many economies to meet the growing need for infrastructure. Economies throughout the region also remain exposed to interest rate and other growth shocks as a result of the recent impact of the financial crisis on advanced economies.

The challenge then is how to increase investment in infrastructure under current fiscal constraints. Increased involvement of the private sector in both financing and delivery of the critical infrastructure will be a key part of the solution and FDI can play a critical role.

Public Private Partnerships – PPPs – are a risk-sharing relationship based on a shared aspiration between the public and the private sectors to deliver a publicly agreed outcome and/or public service. Typically PPPs include the development of infrastructure that is financed by the private sector. Given the success of PPP programmes in advanced economies (e.g., United Kingdom, Australia and Canada), there is substantial interest in using this model in emerging and developing economies as well.

Yet, infrastructure investment in emerging economies takes place in a very different environment. Institutional risks are at their greatest: laws and regulations are incomplete and subject to change, including key issues of debt repayment, returns, property rights, and contracts; institutions are often underdeveloped; and investors face barriers, as discussed previously, in the ability to make and sustain investments. A critical issue for the future is how to provide institutional capacity that builds strong governance systems supported by the rule of law. This is undoubtedly a huge agenda to address, but nevertheless must be resolved if the required investment in infrastructure is to be achieved. As discussed in the next section, strong IIAs can play an important role in reducing risk and promoting the stability and predictability that will be required to stimulate greater FDI flows in complex and long-term infrastructure projects.

A further factor is the absence of what might be called a culture of private sector investment in infrastructure in emerging economies. This in part reflects an unsympathetic legal framework, but it is also a reflection of the lack of expertise in these economies. This issue was the focus of the recent report prepared for the 17th APEC Finance Ministers' meeting in Kyoto, Japan, *Meeting APEC's infrastructure challenge: Breaking the PPP Logjam* (2010). The report called for an "APEC Pilot PPP Mentoring Scheme" that will provide hands-on technical training and impartial expert advice to economies implementing actual PPP projects. In a similar move the APEC Business Advisory Council (ABAC) has brought together key business people who can advise ministers and high level officials in dialogues on how to enhance existing policy frameworks to help private participation in infrastructure PPP projects. Both initiatives attempt to build capability and capacity in the region.

Despite these challenges, the PPP model has been successfully implemented in the region in the energy, telecommunications and transport sectors. Korea implemented a successful programme in the 1990s largely focused on transport. Malaysia, Hong Kong, Mexico, Chile and Peru have all successfully put in place concessions in transport and power. Understandably, these sectors are generally the focus for emerging economies looking for infrastructure investments that pay off rapidly in terms of economic growth. Education, health and other social infrastructure projects, whilst a focus for advanced economies, tend to have longer term pay offs and, therefore, continue to be a secondary priority in the emerging economies.

Private investment in infrastructure is much needed, but there are significant institutional and capability issues that need to be overcome for many APEC economies to attract the FDI and domestic investment that is required. As discussed in the previous sections, addressing barriers to FDI and creating more investment-friendly environments are critical to attract needed FDI. In addition, a number of significant elements or enablers need to be in place to allow PPPs in particular to develop. Many of these elements must be tackled at the individual nation level, for example establishing the political and legal frameworks that create the confidence and lower the risk for the private sector to invest. Other elements seem likely to require initiatives at an international level, including through multilateral institutions and organizations, to promote both capability and capacity building. Creating a mechanism by which PPP expertise can be captured, retained, shared and used within the public sector is invaluable. As discussed below, adopting strong international frameworks through IIAs is also important to reduce concerns over risk and promote even greater stability.

C. International Legal Structures to Promote FDI in the Asia Pacific

International treaty-based investment rules have become an increasingly common feature of the economic landscape. That is true globally and in the APEC region in particular. According to UNCTAD, as of 2010, there were more than 3,000 international investment agreements – IIAs (used here to encompass both investment treaties and investment chapters of regional trade agreements) – in force worldwide. Hundreds of these have at least one APEC economy as a party and more than 60 of them are between APEC economies exclusively or predominantly. Investment rules are also an integral part of the Trans-Pacific Partnership (TPP) negotiations among nine APEC economies – Australia, Brunei Darussalam, Chile, Malaysia, New Zealand, Peru, Singapore, Vietnam and the United States.

As APEC economies consider how best to attract growth-producing, long-term FDI flows and inward stock growth, the question that often arises is how important are treaty-based investment rules in promoting FDI. The academic research on this question is mixed, with some observers arguing that IIAs play an important, if not primary, role in attracting FDI, and others arguing that the correlation between IIAs and FDI is weak or nonexistent.

As discussed above, there are a wide range of factors that economies and investors examine in determining FDI attractiveness. While it likely is the rare case where the existence of an IIA is the sole, decisive factor in an investor's consideration of whether to make an investment in another economy, the existence and quality of an IIA can be significant and, in some situations and economies, may be highly influential. For a multinational enterprise determined to make an investment in the territory of State X, the existence and quality of an IIA between State X and one of the multiple places where the enterprise has existing operations is often an important consideration in how the enterprise structures the investment. Similarly, if an enterprise is determined to make a particular investment and must choose among several equally attractive locations, the presence or absence of an IIA may be influential, along with other key factors. For high-value and complex investments, such as those required in infrastructure, the risk reduction and predictability and stability benefits of an IIA should have an important impact on how an investor evaluates a potential project.

In this regard, an IIA should be considered as playing an important additive role. Taken in isolation, the impact of an IIA may be difficult to discern. But, when considering the factors that work together to make an economy attractive to FDI – including quality of infrastructure, commitment to rule of law, transparency of governance, openness of markets, *etc.* – IIAs undoubtedly are relevant. They help to complete the picture and the proliferation of other legal arrangements such as tax treaties, pension (or so-called double contribution) treaties and intellectual property agreements (such as the recently signed Anti-Counterfeiting Trade Agreement) to address specific issues will undoubtedly make the FDI environment even more attractive.

Given the proliferation of IIAs over the past 15 years and their growing prevalence among the APEC economies in particular, it has become increasingly likely that an investor trying to engage in treaty planning (i.e., structuring its investment in the manner most advantageous from the perspective of protections under IIAs) will have ample opportunity to do so. But how it goes about that planning has become more complex. The question an investor faces today is likely to be not whether the host economy in which it is considering making its investment is party to an IIA but, rather, which of several IIAs will best meet its interests.

As the May 2009 report of the APEC-UNCTAD Core Elements Project found, certain provisions have become "common and relatively standard" in IIAs, and many of these "core elements" have become so common and standard as to constitute "investment principles." Many of these principles can be traced back to APEC's *Non-Binding Investment Principles,* adopted in Jakarta in November 1994. These include obligations with respect to NT, MFN, fair and equitable treatment, full protection and security, expropriation and compensation, and freedom of transfer of proceeds and other investment-related assets into and out of a State. Another provision considered an "investment principle" is the inclusion of an investor-state dispute settlement mechanism allowing an investor of one IIA party to submit claims to international arbitration where disputes arise under the IIA with the host party for the investment. Notably, every APEC economy has adopted investor-state dispute settlement as a core element of at least some, if not all, of its existing IIAs.

One possible consequence of these provisions having become so prevalent is that we may have reached the point where their absence is more remarkable than their presence. In undertaking the due diligence associated with a prospective investment in another economy, most potential investors will undoubtedly confirm that any IIA between its home economy and the prospective host contains all of the core elements considered to be so standard as to constitute investment principles and to inquire further if any of them are missing.

Indeed, the core elements of IIAs have become so common that it may be best to focus any examination of the relationship between IIAs and FDI on the elements that are less common and that cause one IIA to be different from the rest. From an investment-planning perspective, those differences may help influence an investor's decision to source its investment from one place rather than another or to make its investment in one place rather than another.

Several features that distinguish one IIA from another stand out. One is the approach to scheduling sectoral commitments with respect to the NT and MFN obligations. Some IIA parties opt for a "negative list" approach, whereby the NT and MFN obligations apply to a sector *unless* the host party has taken an express exception for that sector. Other IIA parties opt for a "positive list" approach, whereby the NT and MFN obligations apply to a sector *only if* the host party has expressly agreed to have them apply. Among IIAs to which APEC economies are party, the negative list approach appears to be more common, although there are prominent exceptions, such as Thailand's Closer Economic Partnership Agreements with New Zealand and Japan respectively.

Also, with respect to the NT and MFN obligations, there is a divide concerning coverage of the "pre-establishment" phase of investment. Some IIAs extend the obligation not to discriminate on the basis of nationality to activities in connection with making an investment (so-called entry barriers as discussed previously), whereas others confine the obligation to the operation of an investment only after it has been established. Naturally, from an investor's perspective, the right to be free from discrimination even during the exploratory stages may help to make one potential investment location more attractive than others.

Another feature distinguishing IIAs from one another is the presence or absence of exceptions. The tension that underlies any IIA negotiation is the desire, on the one hand, to provide foreign investors assurances that they will enjoy a certain basic level of protection in the host economy while, on the other hand, ensuring that the host economy (including authorities below the central level of government) preserves its sovereign prerogative to regulate in the public interest by adopting and enforcing rules to protect public health and safety, the environment, national security, and other aspects of public welfare. Ordinarily, these objectives will not be in conflict with one another. (If they were, concluding an IIA would be a practical impossibility.) But, when they are, the State necessarily will want to ensure that its sovereign right to regulate will prevail. Thus, IIAs typically contain several clauses that begin with language like, "Nothing in this Agreement shall be construed to preclude a Party from…" Such clauses help ensure that the State preserves the flexibility it sees as necessary to carry out its role in protecting the public interest, even when doing so might be inconsistent with ordinarily applicable IIA obligations. They frequently are included to cover matters such as national security and the stability of the financial system. However, some IIA parties have included clauses to allow greater exceptions in other areas as well.

From the investor's perspective, the proliferation of exceptions beyond ones for national security and financial stability is viewed with great concern given that such provisions may diminish the predictability and stability that IIAs are designed to reinforce.

In analyzing an IIA, it is important to consider not only what kinds of measures are excluded from IIA obligations, but also *how* exceptions are set forth. A given category of measure may be excluded from all obligations or only certain obligations. Or, it may be covered by the IIA's obligations, but subject to special procedures in the event claims concerning that category of measures are submitted to arbitration. (For example, many IIAs require consultations among tax authorities from both the investor's home State and the host State before the investor may submit to arbitration claims that a host State's tax measure constitutes an expropriation.) In some cases, the State parties to an IIA may stipulate that invocation of a particular exception is "self-judging" in the sense that the mere fact of invoking it means that it is deemed to be well-founded.

Given the prevalence of IIAs not only among APEC economies but more broadly throughout the world and the differences that distinguish them, one important way that APEC economies could improve the FDI attractiveness of the region would be through the adoption of the common and high-standard investment rules, potentially through the negotiation and adoption of APEC-wide investment disciplines that include the core elements that each of the APEC economies already has agreed to in its own bilateral or broader arrangements. Such a development would directly build upon APEC's Non-Binding Investment Principles, which include many of the same themes identified by the APEC-UNCTAD's Core Elements Project. Core principles already contained in the bilateral and sub-regional instruments already agreed to by APEC economies include such elements as NT/MFN disciplines, fair and equitable treatment, full protection and security, expropriation and compensation, freedom of transfer of investment-related assets and investor-state dispute settlement. They may also include other disciplines found in some of the APEC economies' IIAs, as well as APEC's Non-Binding Principles, that seek to eliminate other FDI-related barriers, such as performance requirements that mandate use of local inputs rather than imported inputs as a condition of investment or as a condition for gaining access to certain regulatory benefits (so-called localization).

While many of the issues discussed above, and others, would necessarily form part of the negotiation, the end product – convergence towards high-standard APEC-wide investment disciplines – could be a game-changer that would fundamentally establish APEC as a region committed to FDI, helping each APEC economy achieve the FDI growth that is so vital. The inclusion of high-standard investment disciplines in the pathways to FTAAP currently under negotiation or development is a critically important step. Current pathways include the TPP, for which the broad outlines are expected to be determined by the time of the Honolulu APEC meetings, as well as the Comprehensive Economic Partnership in East Asia (CEPEA) and the East Asian Free Trade Agreement (EAFTA). In addition, another potential pathway should include the negotiation of an APEC-wide International Investment Agreement (IIA). The successful inclusion of common, high-standard investment disciplines in the TPP and other potential pathways would provide an important demonstration effect for those economies interested in achieving a high standard agreement that will produce important investment flows. Such a step would also improve the overall quality of the TPP and other pathways in which there is a strong interest among the private sector in securing a high standard outcome on all the core investment elements, as well as other key areas. Furthermore, such steps would help bring further focus to the initiative to create a FTAAP and accelerate the achievement of APEC's own Bogor Goals of free and open trade and investment among all APEC economies by 2020.

IV. Recommendations

APEC has played an important role in advancing and facilitating investment into the APEC region through a variety of investment, infrastructure, transparency, connectivity and other activities since its formation, helping to promote vital economic growth and development. Yet, as competition for FDI increases worldwide, APEC economies' share of world FDI has decreased and the demands for new FDI to support economic growth, infrastructure development and the needs of growing populations are tremendous.

To address the huge investment requirements that the region faces, APEC must reinvigorate its investment and related activities to help ensure that the APEC economies are poised as the top destination for FDI in the decades to come and in ways that will enable the region to tackle the key infrastructure gaps that are increasingly apparent. To do so, the APEC economies should commit to:

- *Reinvigorate the IFAP to Identify Critical FDI Barriers and Priority Actions to Attract Greater FDI Inflows.* APEC's investment work has included important analyses identifying barriers to growth-producing FDI. Building on these and other extensive efforts, APEC's IEG should work with the APEC economies to identify the *key* types of FDI barriers – chokepoints – that are undermining their ability to attract productive, long-term investment. Both entry and operational barriers need to be identified, building off of the issues discussed above. In addition, the IFAP needs to be reinvigorated by identifying key priorities for action, including potentially through the development of Individual Investment Action Plans to help economies address core issues effectively, with a special focus on issues related to attracting infrastructure FDI and including a review mechanism to evaluate progress. Such a review mechanism should consider the use of objective measures to determine progress in creating investment-friendly environments, as well as quantitative measures such as increased investment (overall and on a per capita basis), increased greenfield investments and progress in infrastructure development. Where appropriate, capacity building should be used to complement these efforts. APEC's IFAP activities and its investment agenda would also benefit greatly through the adoption of a more formal mechanism to promote concrete and regularized input from the private sector.
- *Development of a PPP Action Plan to Promote Greater Infrastructure FDI.* As an initial step, APEC economies should review the initial progress of the Pilot PPP Mentoring Scheme adopted by the APEC Finance Ministers in November 2010, and then build off of that pilot program to develop a PPP Action Plan to continue the PPP Mentoring Scheme and undertake additional capacity building and work over the next three years. As well, APEC should work with other multilateral organizations, including the multilateral development banks, to develop critical reforms that enable PPPs and also identify PPP pilot projects to enable APEC economies to road test and gain practical experience in PPP projects.
- *Reaffirm importance of moving quickly towards APEC-wide adoption of common, high-quality investment disciplines and ensure such disciplines are included in negotiations establishing pathways to free trade and investment in the region:* All APEC economies have already embraced IIAs individually (and some as part of sub-regional groupings) that include the core investment principles identified by UNCTAD, and the achievement of an FTAAP eliminating investment barriers has already been endorsed. Moreover various pathways to FTAAP are currently under negotiation in which investment figures prominently. The ability, therefore, to adopt high-standard APEC-wide investment disciplines is certainly achievable if there is the political will. Through an APEC-wide reaffirmation of the importance of moving quickly towards the adoption of common, high-standard investment disciplines, the APEC economies can set themselves apart as the leading region committed to FDI, helping, thereby, to accelerate FDI inflows that are critical to meet pressing infrastructure needs and to accelerate future growth. Such a reaffirmation and work towards convergence of high-standard disciplines will also help ensure that the APEC economies more quickly adopt such core investment disciplines within the context of the FTAAP negotiations and the pathways to FTAAP. Another potential pathway should include the negotiation of an APEC-wide IIA, which would even more clearly signal the APEC economies' commitment to investment. Clearly, there will be issues to discuss and negotiate, but by starting from the recognition that all of the APEC economies have embraced such core factors as non-discrimination, fair and equitable treatment, expropriation and compensation, and investor-state dispute settlement, and by including such disciplines within the context of pathways towards a comprehensive FTAAP as well as negotiating based on the common objective of attracting greater FDI and helping to meet critically important infrastructure demands, there should be more than sufficient common ground to move each of these negotiations towards a successful conclusion and help achieve APEC's own Bogor Goals of free and open trade and investment among all APEC economies by 2020.

Editor

Linda Menghetti, Vice President, Emergency Committee for American Trade (ECAT)

Authors

Darrin Grimsey, Partner, Infrastructure Advisory, Ernst & Young

Matias Mori, Executive Vice President of Foreign Investment Committee, Ministry of the Economy, Government of Chile

Yoon S. Park, Professor of International Business, George Washington University

Theodore R. Posner, Partner, Crowell & Moring LLP

With a preface by Ambassador Michael Moore of New Zealand and an introduction by Sri Mulyani Indrawati, Managing Director of The World Bank

---

Key Terms

Acronyms and Abbreviations

ABAC – APEC Business Advisory Council
ADB – Asian Development Bank
APEC – Asia Pacific Economic Cooperation
BIT – bilateral investment treaty
FDI – foreign direct investment
FTAAP – Free Trade Area of the Asia Pacific
GDP – gross domestic product
IEG – Investment Experts Group
IIA – international investment agreement
IFAP – Investment Facilitation Action Plan
MFN – most-favored nation
NT – national treatment
OECD – Organization for Economic Cooperation and Development
PPP – Public Private Partnership
TPP – Trans-Pacific Partnership
UNCTAD – United Nations Conference on Trade and Development
WTO – World Trade Organization

References

Asian Development Bank and the Asian Development Bank Institute, *Infrastructure for a Seamless Asia,* Asia Development Bank Institute, Tokyo (2009).

APEC, *2010 Guide to Investment Regimes of APEC Member Economies (7th Edition)* (May 2011).

APEC, *Enhancing Investment Liberalization and Facilitation in the Asia-Pacific Region (Stage 1): Reducing Barriers to Investment across APEC to Lift Growth and Lower Poverty* (November 2006).

APEC, *Non-Binding Investment Principles* (November 1994).

Christian Gormsen, *The Declining Barriers to Foreign Direct Investment and How to See Them,* unpublished paper (January 2011).

Heinz Bachmann and Ken Kwaku, *MIGA Roundtable on Foreign Direct Investment Policies in Africa Multilateral Investment Guaranty Agency* (March 1999).

Investment Experts Group, *Enhancing Investment Liberalisation and Facilitation in the Asia-Pacific Region (Stage 2): Reducing Behind-the-Border Barriers to Investment* (August 2007).

James Walsh and Jiangyan Yu, *Determinants of Foreign Direct Investment: A Sectoral and Institutional Approach,* IMF Working Paper, International Monetary Fund (July 2010).

Jesper Jensen, Thomas Rutherford and David Tarr, *The Impact of Liberalizing Barriers to Foreign Direct Investment in Services: The Case of Russian Accession to the World Trade Organization,* unpublished paper (June 6, 2004).

Pierre Guislain, Kusisami Hornberger and Peter Kusek, "Removing Barriers to FDI", *World Finance* (April 20, 2011).

World Bank, *Investing Across Borders* (2010).

UNCTAD, *Core Elements of IIAs: A Cross-Regional Comparative Study* (2010).

UNCTAD, *World Investment Report 2011: Non-Equity Modes of International Production and Development* (July 2011).

NATIONAL CENTER FOR
APEC™
ASIA-PACIFIC ECONOMIC COOPERATION

500 Union Street, Suite 300
Seattle, WA 98101
Telephone: (206)441-9022 • Fax: (206)441-1006
E-mail: info@ncapec.org