

CAFTA's False Promise

By Kevin P. Gallagher | March 21, 2005

The U.S. Congress and the Central American nations are currently considering the Central American Free Trade Agreement. Through CAFTA, Central American governments hope to attract new inflows of foreign direct investment. Washington promises that investment will start flowing if Central American governments agree to far-reaching investment rules.

Central American governments want investment, and the U.S. has investors. Ostensibly there exist real grounds for a deal. But CAFTA countries should be fully aware of all the agreement's details before signing Washington's investment rules.

CAFTA's investment chapter restricts the ability of signatory countries to require that foreign firms adhere to performance requirements, such as local content standards and technology transfer requirements. Traditionally, countries institute performance measures to spur broad economic growth by creating links between foreign firms and the domestic economy. But this would be prohibited.

CAFTA also sets broad rules regarding what constitutes an expropriation, as well as the compensation due to investors if expropriation does indeed occur. Certainly, the U.S. does not want foreign countries to nationalize U.S. firms.

CAFTA's little secret is that it leaves open the possibility that ad hoc investment tribunals will interpret social and environmental regulations as an "indirect expropriation." What's more, the firms themselves (as opposed to states filing on a firm's behalf, as in the World Trade Organization) can file suit for massive compensation from foreign governments. For example, the U.S. firm Occidental Petroleum in 2004 took advantage of a U.S.-Ecuador investment agreement to challenge Ecuador's decision to cancel value-added tax rebates. Occidental was awarded \$71 million plus interest.

One could argue that agreeing to such measures is the price Central American governments need to pay for receiving more investment. The problem is that the investment may not come.

Numerous studies looking at the determinants of foreign investment conclude that trade and investment agreements such as CAFTA are not a main factor in attracting foreign investment.

In 1998 the United Nations Conference on Trade and Development concluded that the impact of these agreements is small and secondary to the effects of other determinants, especially market size. A 2003 World Bank study examined the experience of twenty developing countries between 1980 and 2000 to determine whether agreements that provide assurances to foreign investors did indeed attract foreign investment. The study found that the agreements themselves did not stimulate additional investment. Instead, market size and macroeconomic stability were the key drivers of foreign investment.

A more recent study conducted by two researchers at Yale University examined the relationship between investment agreements and investment flows in the world economy. The researchers found that the number of investment agreements signed by a country with foreign nations has no independent impact on investment flows into the country—except when such countries were regarded as politically risky.

The authors compared investment flows from the United States to countries with which the U.S. has and does not have investment agreements. What they found was a negative relationship. The countries that had signed investment agreements with the U.S. government received less investment. The authors wrote, "Overall, these results indicate that signing an investment treaty with the United States does not correspond to increased foreign direct investment flows."

In the most recent issue of the *Latin American Research Review*, two authors found no independent correlation between trade or investment agreements and increases in foreign investment in the region. My own research leads to similar findings—also showing a negative correlation between U.S. agreements and U.S. investment.

These studies also suggest that the costs of lifting performance requirements and adopting expropriation rules



IRC Americas

www.americaspolicy.org

A New World of Analysis, Ideas, and Policy Options



could very well outweigh the benefits of any investment treaty.

Central American nations should think twice about agreeing to the investment rules in CAFTA.

The U.S. Congress should also think twice before ratifying CAFTA. According to the U.S. government, CAFTA will only benefit the U.S. economy by one hundredth of one percent after it is fully implemented.

The best way for CAFTA to help the U.S. economy is to ensure that Central American countries develop their

economies so they can import more U.S. products in the future. Without the type of investment that boosts the growth of the domestic market, that development won't occur.

Kevin P. Gallagher is research associate at the Global Development and Environment Institute, Tufts University. Gallagher is the author of Free Trade and the Environment: Mexico, NAFTA, and Beyond (Stanford, 2004) and a regular contributor to the Americas Program (www.americaspolicy.org) of the International Relations Center.

Published by the Americas Program of the International Relations Center (IRC, formerly Interhemispheric Resource Center, online at www.irc-online.org). ©2005. All rights reserved.

The Americas Program

"A New World of Ideas, Analysis, and Policy Options"

Founded in 1979, the IRC is a nonprofit policy studies center whose overarching goal is to help forge a new global affairs agenda for the U.S. government and people—one that makes the United States a more responsible global leader and partner. For more information, visit www.americaspolicy.org or email americas@irc-online.org.

Recommended citation:

Kevin P. Gallagher, "CAFTA's False Promise," IRC Americas Program (Silver City, NM: International Relations Center, March 21, 2005).

Web location:

<http://www.americaspolicy.org/commentary/2005/0503cafta.html>

Production Information:

Writer: Kevin P. Gallagher

Editors: Tom Barry and Laura Carlsen, IRC

Layout: Tonya Cannariato, IRC