UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

THE DEVELOPMENT DIMENSION OF FDI: POLICY AND RULE-MAKING PERSPECTIVES

Proceedings of the Expert Meeting held in Geneva from 6 to 8 November 2002

UNITED NATIONS
New York and Geneva, 2003

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UNITED NATIONS PUBLICATION

Sales No. E.03.II.D.22

ISBN 92-1-112596-0 UNCTAD/ITE/IIA/2003/4

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Acknowledgements

This publication was edited by Americo Beviglia Zampetti and Torbjörn Fredriksson under the supervision of Anh-Nga Tran-Nguyen. Desktop publishing was done by Lynda Piscopo and Teresita Sabico.

The Secretariat is grateful to the authors of the articles included in this volume, which were presented at the Expert Meeting on: "The development dimension of FDI: policies to enhance the role of FDI in support of the competitiveness of the enterprise sector and the economic performance of host economies, taking into account the trade/investment interface, in the national and international context", held in Geneva from 6 to 8 November 2002. The views and opinions expressed are those of the authors and not of the United Nations.

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Preface

The past quarter century has witnessed remarkable growth in world foreign direct investment (FDI) flows, spurred by the evolving investment strategies of transnational corporations (TNCs) and the liberalization of national FDI policies. These policy changes have been accompanied by numerous bilateral investment treaties and more recently by a number of regional and interregional agreements on investment.

While FDI offers recipient economies important potential benefits in the form of capital inflows, technology transfer and improved access to export markets and sources of supply, such benefits cannot be taken for granted. Simply opening up to foreign investment does not guarantee inflows, and even when countries do manage to attract FDI, the implications for development differ considerably, depending on the circumstances. For instance, in order to secure the greatest possible positive impact of FDI inflows, a host country needs a minimum absorptive capacity and the ability among its domestic enterprises to link up with foreign-owned companies.

Government policies are vital for enhancing the developmental impact of FDI. Furthermore, at the same time as barriers to cross-border exchanges are being reduced, including in the area of investment, international cooperation has been strengthened through various international agreements to regulate these exchanges. Countries thus need to ensure that policies undertaken at the national level in pursuit of specific development objectives are enhanced, and not hindered, by international rule making.

Certain aspects of international rule making deserve particular attention from a development perspective. Most developing countries are still predominantly net recipients of FDI; very few of them have so far emerged as significant sources of outward FDI. Hence, interest among developing nations in the context of international investment agreements is

likely to focus on ways of enhancing their ability to attract desirable forms of FDI and to realize its potential benefits.

These and many other multifaceted and complex issues have to be considered with great attention. In many parts of society, there is genuine uncertainty as to the advantages and disadvantages of globalization, especially regarding the most visible and widespread form of globalization, which is FDI by TNCs. Concerns have been raised about the expansion of "big business" and its impact on economic and social life. Such questions must be addressed, and new ways explored to facilitate a more equitable distribution of the benefits of globalization, while overcoming problems arising from it. In order to deepen the understanding of these issues, pursuant to a decision by the Commission on Investment, Technology and Enterprise Development at its sixth session, UNCTAD convened an Expert Meeting on the development dimension of FDI in Geneva from 6 to 8 November 2002. The development dimension of FDI has been particularly relevant since the 2001 WTO Ministerial Meeting in Doha in relation to the development implications of, and prospects for, closer multilateral cooperation on long-term cross-border investment, particularly FDI.

This volume contains the written submissions presented by scholars and experts, as well as representatives of the private sector and civil society, at the Expert Meeting. The overview chapter is based on a note prepared by the UNCTAD secretariat for the meeting. The Chairperson's summary of the discussion at the Expert Meeting is also included, reflecting the diversified (and at times contradictory) views expressed by scholars, experts from Governments and non-governmental organizations. The issues addressed are policy measures by FDI host countries, home country measures, the corporate social responsibility of TNCs and the right of countries to regulate. These issues are at the core of the international community's search for a balance between global objectives and the specific needs of developing countries in the area of FDI. The diversity of views expressed by the experts reflected the ongoing debate on the international agenda for investment regimes.

An overview of the issues*

UNCTAD secretariat

Foreign direct investment (FDI) can play a significant role in host economies' development process. In addition to capital inflows, FDI can be a vehicle for obtaining foreign technology, knowledge, managerial skills and other important inputs; integrating into international marketing, distribution and production networks; and improving the international competitiveness of firms and the economic performance of countries. At the same time, neither inflows of FDI nor the benefits from such inflows are automatic.

Governments need to consider what role they want inward FDI to play in their economies' development process, and then design their FDI policies accordingly. Thus, the broad policy objectives are to attract in particular investment that is in line with the identified development objectives; to maximize the potential benefits of FDI; and to minimize negative effects (e.g. balance-of-payments problems, crowding out, transfer pricing, abuse of market power, labour issues and environmental effects). Government intervention (by host or home countries) may be motivated by two primary types of market failures: information or coordination failures in the investment process; and the divergence of private interests of investors (foreign and/or domestic) from the economic and social interests of host economies. To optimize the impact of inward FDI (UNCTAD, 1999), Governments need to address the following four sets of issues:

* This overview is based on the note by the UNCTAD secretariat: "The Development Dimension of FDI: Policies to Enhance the Role of FDI in the National and International Context – Policy Issues to Consider" (TD/B/COM.2/EM. 12/2) prepared for the Expert Meeting on: "The development dimension of FDI: policies to enhance the role of FDI in support of the competitiveness of the enterprise sector and the economic performance of host economies, taking into account the trade/investment interface, in the national and international context", held in Geneva from 6 to 8 November 2002.

- Information and coordination failures in the international investment process;
- Infant industry considerations in the development of local enterprises, which can be jeopardized if inward FDI crowds out those enterprises;
- The static nature of advantages transferred by transnational corporations (TNCs) in situations where domestic capabilities are low and do not improve over time, or where TNCs fail to invest sufficiently in improving the relevant capabilities (an issue that is particularly relevant in the context of linkages between foreign affiliates and local firms); and
- Host country Governments' weak bargaining and regulatory capabilities, which can result in an unfavourable distribution of benefits from the perspective of society (e.g. negative effects on competition or the environment).

In general, developing countries and economies in transition differ from developed countries with regard to the role and impact of FDI in their economies. First, the former are typically net importers of FDI, whereas developed countries in most cases present a more balanced pattern of inward and outward flows of FDI.[1] Thus, in the context of FDI and international investment agreements (IIAs), the primary focus for most developing countries and economies in transition is on issues related to their ability to attract inward FDI and benefit from it. In contrast, questions related to improving access to foreign markets for outward investment are of secondary

[1] The stock of outward FDI from developing countries increased rapidly during the late 1990s and stood at $776 billion in 2001. However, the 10 largest developing-economy sources – with Hong Kong (China), Singapore, Taiwan Province of China and the Republic of Korea in the top four positions – accounted for more than 85 per cent of these investments. Only 15 developing economies and economies in transition reported outward stocks of more than $10 billion in 2001. In 70 countries, outward FDI stocks were below $10 million (UNCTAD, 2002).

importance, at least for the vast majority of developing countries.

Second, the technological gap between domestic and foreign enterprises is generally more accentuated in developing countries and economies in transition. On the one hand, this suggests that these economies should be particularly interested in attracting FDI that can bring much-needed capital, technology and knowledge. On the other hand, weak domestic capabilities hamper the ability to fully reap the benefits of inward FDI. Similarly, whereas inward FDI in countries with relatively unproductive domestic enterprises may provide valuable examples of desirable practices, leading to a rise in productivity, it may also risk crowding out domestic players and may encourage anti-competitive behaviour resulting in welfare losses.

International agreements in general involve binding commitments, which may lead to the convergence of national policies and can limit the policy autonomy of the parties to an agreement. It is therefore important for developing countries to deepen their understanding of what policies and policy tools are most important from a development perspective; how international rules in the area of investment would affect them; and what commitments can be sought from home countries to support their development objectives. The overall question is how IIAs can help developing countries and economies in transition to attract FDI, while allowing sufficient policy space for those countries to regulate in the interest of benefiting as much as possible from such investment.

Section 1 discusses the role of FDI-related host country policies in encouraging synergies between inward FDI and the domestic enterprise sector. Section 2 looks at the potential role of home country policy measures in this context. Section 3 recognizes that IIAs discipline the use of policies undertaken by the parties involved and addresses the role of safeguards and the right of host Governments to regulate.

1. Host country policy measures

Host countries have various policy tools at their disposal to enhance the developmental impact of FDI. Some are of a general nature and aim at enhancing the attractiveness of the business environment (policies aimed at creating political and macro-economic stability and improving infrastructure and human resources; trade policy; science and technology policies; labour laws, etc.). Such policies can be nationwide or specific to sectors or regions. Another set of policies is geared to the development of enterprise capabilities, especially small and medium-sized enterprises (SMEs). Finally, there are policies that consist of rules and regulations governing the entry and operations of foreign investors, the standards of treatment accorded to them and the functioning of the markets in which they are active (UNCTAD, 1996a). While this note concentrates on the last set of policies – since it is most directly related to FDI – it is clear that such policies need to be well integrated into the overall development strategy of a country.

Countries are scaling up their efforts to attract FDI. This can be seen from the ongoing liberalization of FDI policies involving the opening up of sectors and industries (UNCTAD, 2002). Countries at all levels of development are also continuing to enter into bilateral investment treaties (BITs) and double taxation treaties (DTTs). At the close of 2001, a total of 2,099 BITs and 2,185 DTTs had been concluded (UNCTAD, 2002). While the general trend is in the direction of FDI liberalization, simply opening up an economy is often no longer enough to attract sustained flows of FDI and to ensure that FDI brings the expected developmental benefits. TNCs' investment decisions are primarily driven by economic fundamentals (such as market size, the costs and efficiency of production, the quality of infrastructure and access to skills). In response to growing competition for FDI, and to overcome information failures, more and more countries are actively promoting their locations to potential investors. In addition, countries are increasingly adopting a more targeted approach to FDI promotion. Such an approach, while not without risk, has been

found to increase the chances of attracting the type of investment that can advance a country's development objectives (UNCTAD, 2002).

In the absence of an enabling policy environment, TNCs tend to focus on the existing comparative advantages of host countries, especially low labour costs and logistical considerations, when locating their export-oriented activities in developing countries. Capitalizing fully on static benefits and transforming them into dynamic and sustainable advantages therefore require proactive government intervention. The development of domestic skills and enterprise capabilities is particularly important for attracting quality FDI and ensuring that the necessary absorptive capacity is present so that full benefit can be derived from knowledge transfers.

In terms of the core FDI policies, host countries have implemented, or are implementing, various "host country operational measures" (HCOMs) that aim at influencing the operation of foreign affiliates inside their jurisdictions (UNCTAD, 2001a). HCOMs can cover all aspects of investment (ownership and control, hiring of personnel, procurement of inputs, etc.) and usually take the form of either restrictions or performance requirements. They are often adopted in order to influence the location and character of FDI and, in particular, to increase its benefits. HCOMs can be divided into three categories (table 1): "red-light" HCOMs, which are explicitly prohibited by the WTO Agreement on Trade-Related Investment Measures (TRIMs) because of their distorting effect on international trade; "yellow-light" HCOMs, which are explicitly prohibited, conditioned or discouraged by interregional, regional or bilateral (but not by multilateral) agreements; and "green-light" HCOMs, which are not subject to control through any IIAs.

Table 1. Three categories of HCOMs

Category	HCOM
Red-light HCOMs	• Local content requirements • Trade-balancing requirements • Foreign exchange restrictions related to foreign exchange inflows attributable to an enterprise • Export controls
Yellow-light HCOMs	• Requirements to establish a joint venture with domestic participation • Requirements for a minimum level of domestic equity participation • Requirements to locate headquarters for a specific region • Employment performance requirements • Export performance requirements • Restrictions on sales of goods or services in the territory where they are produced or provided • Requirements to supply goods produced or services provided to a specific region exclusively from a given territory • Requirements to act as the sole supplier of goods produced or services provided • Requirements to transfer technology, production processes or other proprietary knowledge • Research and development requirements • Measures contrary to the principle of fair and equitable treatment
Green-light HCOMs	• All other HCOMs

Source: UNCTAD (2001a, p. 3).

At the multilateral level, the TRIMs Agreement prohibits not only TRIMs that are mandatory in nature but also those that are linked to the receipt of an advantage. It applies only to investment measures related to trade in goods and not trade in

services.[2] While such measures frequently arise in the context of foreign investment policies, the Agreement applies equally to measures imposed on domestic enterprises. For example, a local content requirement imposed in a non-discriminatory manner on domestic and foreign enterprises is inconsistent with the TRIMs Agreement because it involves discriminatory treatment of imported products in favour of domestic products.

Some regional agreements also address these and additional performance requirements. The North American Free Trade Agreement (NAFTA), for example, forbids local equity requirements (Art. 1102(4)). Article 1106(1) proscribes the imposition or enforcement of mandatory requirements and the enforcement of any undertakings or commitments to (a) export a given level or percentage of goods or services; (b) achieve a given level or percentage of domestic content; (c) purchase, use or accord a preference to goods produced or services provided in the territory of a party or to purchase goods or services from persons in its territory; (d) relate the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with investment; (e) restrict sales of goods or services produced or provided by an investment in a party's territory by relating such sales to the volume or value of exports or foreign exchange earnings of the investment; (f) transfer technology, a production process or other proprietary knowledge; or (g) act as the exclusive supplier of the goods produced or services provided by an investment to a specific region or world market.[3]

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[2] Measures concerning service industries are addressed by the General Agreement on Trade in Services (GATS), which does not contain explicit rules dealing with TRIMs, although these may be subject to specific negotiated commitments. Article XIX.2 of the GATS explicitly grants appropriate flexibility to developing countries to attach conditions when making access to their markets available to foreign service suppliers, provided these conditions are aimed at achieving the objectives set out in Article IV of the GATS (increasing participation of developing countries in world trade).

[3] Requirements (a) and (b) refer only to goods, and (d) and (e) are also prohibited if applied as conditions for the receipt of an advantage (Article 1106(3)). However, parties are free to make receipt of an advantage conditional on compliance with requirements, in connection with an investment, to locate

Similar provisions are found, for example, in the 1997 Canada–Chile Free Trade Agreement (Article G-06), the 1997 Mexico–Nicaragua Free Trade Agreement (Article 16-05), and the 2000 Free Trade Agreement between Mexico and El Salvador, Guatemala and Honduras (Article 14-07). Article 13 of the 1985 United States–Israel Free Trade Agreement forbids the use of local content and export performance requirements. Prohibition of a wide range of performance requirements is also to be found in the 2002 Agreement between Singapore and Japan for a New Age Economic Partnership. On the other hand, the 1994 Treaty on Free Trade between Colombia, Venezuela and Mexico explicitly allows the imposition of requirements to locate production, generate jobs, train workers or carry out research and development (Article 17-04).

The usefulness of various performance requirements remains an area in need of more research. While some studies question the effectiveness of performance requirements, others argue that current IIAs go too far in curtailing the ability of host Governments to improve the quality of FDI in line with their development objectives.[4] As regards future negotiation of IIAs, there may be a need for further assessments of the impact of existing agreements at the bilateral, regional and multilateral levels on the use and impact of performance requirements.

To avoid deterring FDI, performance requirements have normally been tied to some kind of advantage, often in the form of incentives. Most developed countries offer locational incentive packages to both domestic and international investors. Developing countries also offer tax breaks and locational packages to attract foreign investors. However, their packages are much smaller, and these countries typically rely relatively more on fiscal measures, whereas financial incentives are more

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production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development on their territories (Article 1106(4)).

[4] See, for example, Caves (1996); Hackett and Srinivasan, (1998); Moran, (1998, 2001); Kumar (2001); OECD (1998); UNCTC (1991); and WTO (1998) for a discussion of the role of performance requirements.

common in developed countries (UNCTAD, 1996b; UNCTAD, 2000). In developing countries, incentives have been used particularly to attract export-oriented FDI, often in the context of export processing zones (EPZs). In the light of restrictions under the WTO Agreement on Subsidies and Countervailing Measures (the SCM Agreement), developing country WTO members (other than those mentioned in Annex VII of the SCM Agreement and with the exception of those that obtain an extension of the transition period) will have to eliminate export subsidies (related to goods), as required under the SCM Agreement, by 1 January 2003. Even those obtaining an extension of the transition period cannot increase the level of their export subsidies, are subject to the prohibition with respect to particular products if they achieve export competitiveness in such products, and will need to consider what to do once the transition period expires (UNCTAD, 2002).

At the same time, it is worth reflecting on the legal regime for development-related subsidies. For instance, subsidies to foreign affiliates and/or domestic firms that engage in linkage development activities in developing countries, involving the provision of technology, technical assistance and training to local suppliers and their personnel, may be an important policy tool. A case could be made for, under specified conditions, making certain types of such development-oriented subsidies to foreign affiliates non-actionable under WTO rules (UNCTAD, 2001b; UNCTAD, 2002).

Incentives and performance requirements have been used generally in combination with other policy measures to optimize the impact of FDI. In countries in which such measures have played a role in efforts to promote inward FDI, they have typically complemented a range of other measures such as those aimed at enhancing the level of skills, technology and infrastructure. If the business environment is not made more conducive to investment, upgrading and linkages, the risk increases that investors will leave once an incentive expires.

Partly as a result of the liberalization of regulations governing the entry of foreign investors, regulatory policies to ensure the smooth functioning of markets become more important. They may involve the adoption of competition rules, merger reviews, environmental laws and stricter financial accounting standards. For many developing countries and economies in transition, the transition from more interventionist policy approaches (at the point of FDI entry) to the regulation of markets is difficult because of a lack of financial and human resources.

2. Home country policy measures

Host country policies can be supported by home country measures (HCMs). Home countries influence FDI flows in various ways, including the likelihood that their TNCs will select certain locations.[5] The overriding question in this section is therefore how HCMs, in the context of IIAs, can help developing countries and economies in transition to attract and benefit from FDI. This is of particular relevance given the discrepancy between developed and developing countries in terms of the balance between inward and outward FDI.

Developed countries have removed most national restrictions on outward FDI, but policy declarations aimed at encouraging outward FDI are seldom linked to any specific commitments in IIAs (UNCTAD, 2001c). Most assistance remains at the discretion of each developed country and is commonly shaped to serve a home country's own business interests along with general development objectives. This home country perspective is especially evident in the design of many financial or fiscal assistance programmes as well as preferential market access measures. The weak link between the explicit needs of developing countries and the design and execution of

[5] An UNCTAD Expert Meeting on Home Country Measures was held in Geneva from 8 to 10 November 2000. The meeting's outcome is outlined in UNCTAD (2001c).

HCMs, as well as the often uncertain commitment to the duration of assistance, may diminish the beneficial impact that such programmes can have on development.

Relevant HCMs can, for example:

- Aim at improving the economic fundamentals of host countries – for example, through developing human resources, building institutional capacity and assisting in the design and implementation of adequate framework conditions in relevant policy areas;
- Help to reduce the types of information failures in the investment process alluded to above by assisting in the dissemination of investment opportunities in developing countries and economies in transition;
- Improve market access and facilitate export flows from developing countries;
- Provide investment guarantees and insurance;
- Provide risk and venture capital;
- Support linkage promotion programmes; and
- Commit to transfers of technology.

Most developed countries (and a number of other countries) engage in some of these activities, albeit largely on an autonomous basis and in a rather uncoordinated fashion. (For example, there are at least 12 European development finance institutions providing long-term financing for private-sector development in developing and transition economies; see e.g. http://www.edfi.be.) Other institutions providing financial assistance at the international level include the World Bank Group, regional multilateral development banks, the Commonwealth Private Investment Initiative and various privately sponsored investment funds (Hughes and Brewster,

2002). An example of an internationally agreed approach is the Cotonou Agreement.[6]

As the transfer of technology is a central element in many IIAs, the objective of capacity building is often to enable developing country parties to comply with their commitments under the instruments addressing technology issues. Many technology-related provisions rely on HCMs for their implementation.[7] For example, Article 66.2 of the TRIPS Agreement stipulates that developed countries "shall provide incentives to enterprises and institutions in their territories" in order to promote and encourage transfer of technology to LDCs to "enable them to create a sound and viable technological base". Although this provision leaves great leeway to member States to determine what kind of incentives to apply, it does require the establishment of some system encouraging transfer of technology to LDCs. It also provides a general objective that may help to assess the appropriateness of such incentives, since they should enable LDCs "to create a sound and viable technological base".[8]

[6] The 2000 Cotonou Agreement (Partnership Agreement between the African, Caribbean and Pacific Group of States (ACP), of the one part, and the European Community and its Member States of the other part, signed in Cotonou on 23 June 2000), building upon the provisions of the previous Lomé Conventions, includes extensive provisions on investment promotions, finance and support as well as investment guarantees; see Chapter 7: Investment and Private Sector Development Support, in *Official Journal of the European Communities*, L 317 of 15 December 2000. The Agreement is not yet in force.

[7] An Expert Meeting on International Arrangements for Transfer of Technology: Best Practices for Access to and Measures to Encourage Transfer of Technology with a View to Capacity-Building in Developing Countries, Especially in Least Developed Countries, was held in Geneva from 27 to 29 June 2001. Its outcome was an input for policy considerations at the sixth session of the Commission on Investment, Technology and Related Financial Issues, held from 21 to 25 January 2002 (TD/B/COM.2/ L.16, 29 January 2002).

[8] For a compilation of provisions in international arrangements for the transfer for technology, see UNCTAD, (2001e).

The practical effectiveness of HCMs is likely to increase in proportion to the strength of the policy commitments contained in IIA provisions, running along a continuum from hortatory declarations to binding obligations accompanied by detailed implementation plans (backed by financial resources) and monitoring mechanisms. Some IIAs include for this purpose a provision for the establishment of a "Supervisory Committee" to ensure the proper implementation of what has been agreed.[9]

A related policy area is that of the social responsibility of corporations.[10] The concept of corporate social responsibility is potentially very broad and may encompass most matters pertaining to the economic and social impact of TNCs. In a more narrow sense, a number of aspects – including development obligations, socio-political obligations and consumer protection – have received some attention, and others (such as corporate governance, ethical business standards and the observance of human rights) are emerging. Issues related to corporate social responsibility are typically not covered by IIAs but are receiving increased attention in various international agreements and forums.[11] The challenge is to balance the promotion and protection of liberalized market conditions for investors with the need to pursue development policies. Social responsibility standards must be applied with sensitivity to the realities of local conditions in developing countries and should not be misused for protectionist purposes.

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[9] See e.g. Chapter 1, Article 8 of the Agreement between Japan and the Republic of Singapore for a New Age Partnership.

[10] For a discussion of this concept, see for example UNCTAD, (1999, pp. 345–70), and UNCTAD, (2001f).

[11] Examples include non-binding recommendations in the OECD Guidelines for Multinational Enterprises, the ILO Tripartite Declaration of Principles Concerning Transnational Corporations and Social Policy, the United Nations Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices and the Global Compact of the United Nations Secretary-General.

3. The right to regulate

The Doha Ministerial Declaration, in the context of the relationship between trade and investment, states in paragraph 22: “Any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host Governments, as well as their right to regulate in the public interest”.

International agreements, like other legal texts, are specifications of legal obligations, which as such limit the sovereign autonomy of the parties. As international legal obligations generally prevail over domestic rules, a tension is created between the will to cooperate at the international level through binding rules and the need for Governments to discharge their domestic regulatory functions.[12] Such tension is generally captured by the notion of the “right to regulate”, which is central to the question of preserving the national policy space for Governments to pursue their development objectives.[13]

There are various ways to address the issue of the right to regulate. Some of these, with regard to both trade and investment agreements, are reviewed below. In all cases the ability of signatories to regulate the domestic economy is a governing concern. Insofar as this concept is restated in an agreement – for instance, in its preambular language – it also serves an interpretive function vis-à-vis the provisions of the agreement. Furthermore, whenever countries enter into

[12] There is no common understanding of the notion of regulation. In the OECD context “regulation refers to the instruments by which governments place requirements on enterprises, citizens, and government itself, including laws, orders and other rules issued by all levels of government and by bodies to which governments have delegated regulatory powers. Economic regulation intervenes directly in enterprise and market decisions such as pricing, competition, market entry or exit. Social regulation protects values such as health, safety, the environment and social cohesion. Administrative regulation concerns government formalities and paperwork, so called “red tape” (OECD, 1997, p. 2).

[13] The need to balance the public interest pursued through regulation and private rights is also common at the national level.

standard-of-treatment obligations, such as fair and equitable treatment, prohibition of arbitrary and discriminatory measures or most-favoured-nation treatment (MFN) and national treatment, various kinds of exceptions, reservations, derogations, waivers or transitional arrangements ensure that signatories retain their prerogative to apply non-conforming domestic regulations in certain areas. These can be general (e.g. for public order or national security), subject-specific (e.g. the "cultural exception") or country-specific (e.g. as in the case of GATS schedules of commitments, with regard to commercial presence).

Various safeguards are also used to preserve the right to regulate, as in the case of transfer-of-payments and balance-of-payments safeguards. Furthermore, time-bound safeguards are often allowed as a measure to enable a country to safeguard its domestic production against a surge of imports.[14] It is necessary to examine to what extent such a concept of "safeguards" could also be used in the area of investment.

The issue of the right to regulate has been dealt with largely in international agreements on trade, and useful concepts and approaches that have been defined in this context have also been used in the context of IIAs. In the area of *trade,* the issue has been debated and litigated at length in the GATT/WTO system, where the dispute settlement process has been frequently used to police domestic regulatory measures that have an impact on trade. The main instrument for policing regulatory activities in the WTO comes from the 1947 GATT and is found in Article III's non-discrimination (national treatment) obligation as complemented by the exceptions

[14] For instance, in the framework of the WTO Agreement on Safeguards, if a production sector in a country suffers because of increased imports, the country is authorized to restrict imports temporarily by imposing higher tariffs or by directly limiting import quantities under certain conditions ("as to cause or threaten to cause serious injury to the domestic industry that produces like or indirectly competitive products"). The main rationale for this provision is that the particular sector in the country should be allowed time to adjust itself to the new situation of competition from imports.

contained in Article XX. The general national treatment rule contained in Article III provides that internal taxes and regulations must not treat imports less favourably than domestic products. If a domestic regulatory measure is found to discriminate against imports, the regulating Government may attempt to justify the discrimination by proving that it is necessary in order to achieve some legitimate purpose. Article XX of GATT defines these exceptions to include those necessary to protect public morals; those necessary to protect human, animal and plant life or health; and those relating to the conservation of exhaustible resources. It should be noted that this list of policies that can justify measures otherwise considered in violation of national treatment is "closed" and thus provides limited scope for claiming an exception in many areas where countries may want to pursue regulatory action.

A justification for *de jure* discrimination (that explicitly distinguishes goods by origin) is particularly demanding since the country claiming the exception has to prove that there is no less burdensome alternative to the measure in question. In the case of *de facto* discrimination (not based on the origin of the goods), the central issue is that imports are treated less favourably than "like" domestic products. For a regulation to produce a difference in treatment, it must divide products into two or more categories. It is generally assumed that product distinctions that can be recognized under Article III relate to the qualities and physical properties of the products themselves or to characteristics of the production processes (e.g. hygiene) or of the producers (e.g. certification that they meet certain standards) that directly affect product qualities. Likeness is also traditionally determined in the light of factors such as physical similarity, tariff classification, inter-changeability by consumers and end uses. In general, likeness indicates that products are competitive and thus that discriminatory treatment has an adverse effect on the competitiveness of the less favoured product.

The WTO Agreement on Technical Barriers to Trade explicitly calls for an integrated examination of the *purpose* of the measures in question and its *trade-restricting effects*. The Agreement clearly requires a balancing of the degree of trade restriction against the regulatory purpose of the disputed measure. Furthermore, the analysis of the regulatory aim is part of the review of the legality of the measure itself, with an illustrative (not closed) list of legitimate objectives. In this context, there is no need to first establish a violation (which requires a conclusive determination of likeness), followed by a review of the regulatory justification by way of exception. The balancing analysis also calls for an appreciation of the trade effects in the light of existing less restrictive alternatives and of the risk of non-fulfilment of the regulatory objectives.

The GATS deals extensively with commercial presence of service providers, and thus its provisions are particularly relevant in the area of *investment*. GATS in its preamble recognizes "the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives and, given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right".

The services sector is highly regulated in many countries for the purpose of consumer protection, security, protection of public morals and prudential measures. While the GATS recognizes the sovereign right of a country to regulate services for legitimate purposes, Article VI seeks to prevent the use of administrative decisions to disguise protectionist measures. Generally applied measures that affect trade in service sectors for which a country has made commitments must be applied reasonably, objectively and impartially. Applications to supply services under such commitments must receive a decision within a reasonable period of time. The Council for Trade in Services is called on to develop rules to prevent requirements governing qualifications for service suppliers, technical standards or

licensing from being unnecessary barriers to trade.[15] Until such multilateral rules are ready, Governments are to follow (in sectors in which they have undertaken specific commitments) the same principles in applying their requirements and standards, so that these do not nullify or impair specific commitments (on market access and national treatment) they have made.

The GATS, in Article XVII on national treatment, does not limit the distinction between services and service providers to the characteristics of the product, as is the case under GATT Article III. Other *regulatory distinctions* of otherwise "like" services and service providers are available. Obviously, origin-specific discrimination is forbidden. With regard to origin-neutral regulatory distinctions, these can create a disproportionate burden for foreign services and service suppliers and thus be challenged as *de facto* discrimination. The market effect is part of the analysis, as Article XXVII(3) states that "Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member".

The determination of likeness does not appear to be easier under the GATS than under the GATT. Probably the most meaningful element is that of "end use", together with the related concepts of direct competitive and substitutable services. Once likeness is determined and less favourable treatment found, then, rather as with the GATT, a general exception under Article XIV can be invoked. The key additional element in the GATS is that the national treatment obligation does not apply across the board but only "In the sectors inscribed in [the WTO

[15] A separate Ministerial Decision has launched this programme by establishing a GATS working party to prepare rules for the requirements that Governments impose on professional service suppliers. The first disciplines to be drawn up apply to technical standards, qualifications and licensing requirements for accountancy services.

Member's] Schedule, and subject to any conditions and qualifications set out therein" (i.e. the member's specific commitments). Thus, each member first decides which services sector will be subject to the GATS national treatment discipline, and then exempts those measures that it wishes to keep in place even though they represent a violation of national treatment. The exact content of the national treatment obligation under the GATS and any limitation on regulatory action are therefore determined not only by the interaction of the national treatment provision and the general exceptions but, and perhaps more importantly, by the extent of the limitations inscribed in each member's schedule.

Issues related to the right to regulate first arose in the context of investment protection agreements, with regard to the issues of expropriation and nationalization. Some regional agreements and virtually all bilateral investment treaties include broad language covering measures "tantamount" or "equivalent" to expropriation. Hence, they can also apply the expropriation provisions to "indirect expropriations" or "regulatory takings", namely when a host country takes an action that substantially impairs the value of an investment without necessarily assuming ownership of the investment. Furthermore, a number of BITs and regional investment agreements are also understood to apply the expropriation provision to "creeping expropriations" – that is, expropriations carried out by a series of legitimate regulatory acts over a period of time, whose ultimate effect is to destroy substantially the value of an investment. They generally impose certain conditions on expropriation if it is to be considered lawful, by adopting some variation of the traditional rule of international law that a State may not expropriate the property of an alien except for a public purpose, in a non-discriminatory manner, in accordance with due process of law and upon payment of compensation. Concerns have been expressed with regard to the impact that an expansive use of expropriation claims may have on sovereign Governments' right to regulate. In the context of the NAFTA, the three member countries in 2001 adopted some Notes of Interpretation of Certain Provisions of the investment chapter to clarify the provision governing the

minimum standard of treatment to be accorded to foreign investors. They determined that the NAFTA's standard is the customary international law minimum standard of treatment.

Moving to the area of *national treatment*, the NAFTA, for example, subsequently followed by a number of other free trade agreements, took an approach similar to that of the GATS. Each Party is required to accord the better of national treatment (and MFN) treatment to investors of another Party, and to investments of investors of another Party "in like circumstances", with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments (Articles 1102–1104). However, the Agreement's investment provisions, including those governing national treatment, are determined by the *exceptions* and *reservations* provided for in Article 1108 and contained in the annexes to the Agreement. Furthermore, the Agreement provides that nothing in the investment chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure, otherwise consistent with the Chapter, "that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns" (Article 1114). The NAFTA also incorporates by reference the provision of GATT Article XX (Article 2101) and provides for a general national security exception (Article 2102).

BITs similarly limit the coverage of national treatment by including qualifications, exceptions or derogations (UNCTAD, 1998). As in the context of trade, MFN or national treatment provisions are often limited to investments that are "in the same circumstances" or "in like situations" or that are made by a "similar enterprise". Such provisions, however, do not identify the criteria by which similarity or likeness is to be established. The determination might depend, for example, on whether the two investments are in competition with each other. In OECD country practice, for example, the specific criteria to be taken into account include whether the two enterprises are in the same industry, the impact of policy objectives of the host

country in particular fields and the motivation behind the measure involved. Another question that arises is whether the MFN or national treatment obligation applies to special treatment granted to certain individual investors or to all investors of a particular nationality (UNCTAD, 1998).

General exceptions are often agreed for reasons of "public security and order, public health and morality". Exceptions can also apply to the treatment accorded under international treaties or domestic legislation relating to taxation. In other words, the exception permits a country to provide favourable tax treatment for investment by national companies without according the same treatment for investment by foreign companies, or vice versa. Finally, a few BITs allow exceptions to national treatment on the basis of development provisions. An example of such an exception is found in Protocol No. 2 of the BIT between Indonesia and Switzerland, which allows derogation from national treatment of Swiss investors "in view of the present stage of development of the Indonesian economy".[16] Development considerations seem also to play a role in the case of Germany's approach in BITs to national treatment, insofar as the country has accepted certain exceptions to the national treatment principle, provided that these are undertaken for development purposes only (e.g. to develop small-scale industries) and that the measures do not substantially impair investments by German investors (UNCTAD, 1998).

Concerning exceptions to *transfer of payments*, the possibility for a Government to intervene is generally provided, with a number of qualifications. In a regional context, for instance, the 2000 Free Trade Agreement between Mexico and El Salvador, Guatemala and Honduras provides for the possibility of introducing temporary exchange controls in the event of a serious balance-of-payments disequilibrium. However, measures have to be compatible with internationally

[16] However, Indonesia, pursuant to the terms of the treaty, would grant "identical or compensating facilities to investments and nationals of the Swiss Confederation in similar economic activities".

accepted criteria. In the context of the Economic Partnership Agreement between the European Union and Mexico, the Parties agreed that in the event of serious balance-of-payment difficulties, restrictive measures with regard to payments, including transfer of proceeds from the total or partial liquidation of direct investment, could be adopted on a non-discriminatory and time-bound fashion. The NAFTA provides for the possibility of adopting measures that restrict transfers in the event of serious balance-of-payment difficulties, subject to a series of conditions (such as avoiding unnecessary damage to the commercial, economic and financial interests of another Party, not being more burdensome than is necessary for dealing with the difficulties, and being temporary and non-discriminatory).

Many BITs allow exceptions to the obligation of free transfer of payments only during periods when foreign currency reserves are at exceptionally low levels. Such clauses generally allow the transfer to be delayed temporarily. Sometimes they are subject to one or more other conditions. Another approach confers the right to make monetary transfers, but subject to the exchange control laws of the host country. Some BITs guarantee the right to transfer only a fraction of the earnings of wages of nationals of the other contracting party to that home country.

In conclusion, while international rules obviously imply a measure of restriction on domestic regulatory autonomy, several techniques have been used to strike the right balance. The GATT, the Agreement on Technical Barriers to Trade (the TBT Agreement) and the GATS all use different approaches and may provide useful reference models for any future rule-making in the area of investment. With regard to both regional and bilateral IIAs, it is necessary to examine to what extent the right to regulate goes beyond "regulatory takings" and similar issues of investment protection to encompass the way in which other areas covered in IIAs can be reconciled with the necessary preservation of policy space for development.[17]

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[17] The issue was also discussed at the UNCTAD Expert Meeting on Bilateral and Regional Approaches to Multilateral Cooperation in the Area of

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Long-Term Cross-Border Investment, particularly FDI. The report of the Expert Meeting notes: "Finally, the question was raised whether the right to regulate would go beyond expropriation issues and cover performance requirements and other conditions imposed on foreign investors" (TD/B/COM.2/EM.11/3, para. 18(g)).

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PART I

Host country policy measures

Globalization and FDI policies

Ari Kokko

1. Introduction

While aid and concessional loans used to account for the bulk of resource flows from the Organisation for Economic Co-operation and Development (OECD) to developing countries a couple of decades ago, foreign direct investment (FDI) is now the main source of development capital. Table 1 shows that the resource flows to developing countries have roughly doubled since the early 1990s, and that the most dramatic increases have been in private capital flows, particularly FDI. This tremendous increase in FDI is largely driven by the globalization of the world economy. The scope for multinational production has expanded as GATT's Uruguay Round and various regional integration agreements have reduced the barriers to international trade and investment, at the same time as important technical innovations in telecommunications and information technology have facilitated the coordination of international production networks. As a result, the importance of market size as a determinant of investment location has diminished. Even small countries may now compete for FDI, given that they can provide sufficiently attractive production conditions for foreign investors.

Table 1. Net resource flows to all developing countries
(Million US$)

	1970	1980	1990	1995	2000	2001
Net resource flows	11 177	82 816	99 148	260 193	261 133	194 477
Official net flows (grants and concessional loans)	5 383	34 993	55 591	54 053	35 287	36 508
Private net flows (portfolio capital and FDI)	5 794	47 823	43 557	206 139	225 846	159 970
Share of FDI in net resource flows	0.20	0.05	0.24	0.41	0.64	0.86

Source: World Bank (2002), p. 22.

With few alternative sources of investment capital and at least a potential to attract FDI, it is not surprising that the attitudes towards inward FDI have also changed over the last couple of decades. Almost all countries have liberalized their FDI policies, and an increasing number of host Governments provide various forms of investment incentives to encourage entry by foreign-owned companies. These include fiscal incentives such as tax holidays and lower taxes for foreign investors, financial incentives such as grants and preferential loans to transnational corporations (TNCs), and measures such as market preferences, infrastructure and sometimes even monopoly rights. To ensure that the incoming FDI generates the expected positive effects, many countries have also decided to balance the preferences given to foreign investors with various performance requirements.

However, at the same time as WTO and various regional agreements have contributed to the proliferation of FDI incentives, the agreements have also changed the balance between incentives and performance requirements. Local content requirements, export controls and some other types of host country policies have been explicitly prohibited, and many other kinds of requirements are subject to discussion. As a result, it has become more difficult to design policy packages that optimize the joint objectives of maximizing both FDI inflows and the beneficial development effects of the incoming FDI. There are question marks regarding the effects of incentives, and how effective they are in attracting FDI is still discussed. Incentives transfer surplus and profits from the host country to TNCs, and it is not clear whether the benefits generated by foreign investments are large enough to justify the very substantial costs involved – in many cases, the subsidy per job created has amounted to tens of thousands of United States dollars. There is also concern that the competition between host countries will lead to increasingly generous subsidies, to the benefit of foreign investors but at the expense of host countries. Furthermore, it is unclear what performance requirements are reasonable, given the restrictions posed by WTO and other international agreements. This note addresses some of these

issues, beginning with a discussion about the rationality of FDI incentives, and continuing to some comments about policy alternatives.

2. Are FDI investment incentives justified?

Views on the importance of FDI incentives have begun to change during the past decade. Until recently, there was a strong consensus in the literature that FDI is mainly attracted by strong economic fundamentals. The most important are market size and income level, with skills, infrastructure and other resources that facilitate efficient specialization of production, trade policies, and political and macroeconomic stability as other central determinants. This hierarchy of host country characteristics largely assumed that FDI was market-seeking, and investment incentives were seen as relatively minor determinants of FDI decisions. While they might tilt the investment decision in favour of one of several otherwise similar investment locations, the effects were considered only marginal. Globalization has changed this picture and made incentives a more important determinant of international investment decisions.

One indication is the proliferation of investment incentives across the world. More than 100 countries provided various FDI incentives already in the mid-1990s, and dozens more have introduced such incentives since then – few countries compete for foreign investment without any form of subsidies today (UNCTAD, 1996). In developed countries where financial incentives are common, the subsidies per FDI-related job often total tens of thousands of United States dollars (UNCTAD, 1995). In developing countries, incentive schemes are often based on tax holidays and other fiscal measures that do not require direct payments of scarce public funds, and where costs are harder to calculate. While TNC executives used to downplay the role of incentives some years ago, they now readily admit their increasing importance for investment decisions (Easson, 2001). Even econometric studies, which

used to find small or no effects of incentives, now suggest that they have become more significant determinants of international direct investment flows (Clark 2000; Taylor, 2000).

Hence, it seems clear that FDI incentives are effective in the sense that they influence FDI flows. Yet it is not obvious whether they are also efficient – in other words, whether the benefits to the host country are at least as large as the costs of providing the incentives. To explore the efficiency issue, it is necessary to briefly consider the motives for FDI incentives.

Although FDI incentives are sometimes motivated by temporary macroeconomic problems such as weak growth and rising unemployment, there are also more substantial arguments in favour of public support to FDI. One obvious motive for incentives is the presence of formal or informal rules discriminating against foreign investors (such as export or local content requirements). However, in these cases, the first best solution would probably be the removal of the discriminating rule rather than the introduction of an investment incentive. The strongest arguments are instead based on prospects for knowledge spillovers.[1] Foreign firms differ from local firms because they possess proprietary technology or other assets that allow them to compete in a foreign environment. Since technology and knowledge to some extent are public goods, foreign investment can result in benefits for host countries even if foreign multinationals carry out their operations in wholly owned affiliates. These benefits take the form of various types of externalities or "spillovers". For instance, local firms may be able to improve their productivity as a result of forward or backward linkages with TNC affiliates, they may imitate TNC technologies or hire workers trained by TNCs. The increase in competition that occurs as a result of foreign entry may also be

[1] It is also possible to justify FDI incentives with arguments based on capital market imperfections, assuming that foreign multinationals have better access to capital, or labour market imperfections, assuming that unemployed workers would not find new jobs in the absence of FDI. See Blomström and Kokko (2002).

considered a benefit, particularly if it forces local firms to introduce new technologies and reduce slack. However, the foreign TNCs will not include these spillovers in their private assessment of the costs and benefits of investing abroad, and may therefore invest less than what would be socially optimal. The motive for public subsidies to foreign investors is to bridge the gap between the private and social returns, thus promoting larger inflows of FDI.[2]

This means that the efficiency of FDI incentives is related to the magnitude and character of spillovers. Few commentators have assessed the empirical evidence regarding productivity and technology spillovers in connection with the debate on FDI incentives, but rather assumed that they are sufficiently large and positively related to the amount of FDI or the employment created by FDI. However, the empirical evidence on spillovers is mixed. There is plenty of case study evidence of positive externalities, but there are also more aggregated studies finding no significant spillovers at the national level. A detailed review of the evidence lies outside the scope of this note (see Blomström, Kokko and Zejan, 2000, for a recent survey), but there is a pattern emerging from the empirical findings in the literature. In brief, it seems clear that host country and host industry characteristics determine the impact of FDI, and that systematic differences between countries and industries should be expected. There is strong evidence pointing to the potential for significant spillover benefits from FDI, but also ample evidence indicating that spillovers do not occur automatically. Most importantly, it appears that the ability and the motivation of local firms to engage in investment and learning to absorb foreign knowledge and skills are a central determinant of whether or not the potential spillovers will be realized.

[2] Without these gaps (or rules discriminating against foreign investors), it is hard to motivate specific FDI incentives (aside from the provision of information). In such cases, subsidizing foreigners would only distort competition and hurt local firms, which is presumably against the interest of the host country. However, these concerns do not rule out general investment subsidies that are available on equal terms to local as well as foreign firms.

Taking these findings into account, it is not obvious that FDI incentives are efficient. In fact, it is possible that the competition between potential investment locations, internationally or within countries, will raise the subsidy levels so much that most of the benefits are shifted from the host country to the foreign investors even when there are substantial spillovers (Haaland and Wooton, 1999).[3] At the same time, it is understandable that many countries are unwilling to give up their promotion efforts. While it may be difficult to determine the exact impact of incentives for the reasons discussed above (and because the level of subsidies may be negatively related to the ability to attract FDI) there is a consensus that the unilateral withdrawal of investment incentives would be costly for any individual country (Head, Ries and Swenson, 1999). Incentives may also be politically attractive. One reason is that offering generous incentives gives the impression that the Government is actively trying to promote local development. This is particularly important because national decision-makers have lost many of the instruments traditionally used to promote local competitiveness, employment and welfare. For instance, globalization has reduced the scope to use active trade policy and exchange rate policy as a tool to influence relative competitiveness. Another reason is provided by the structure of costs and benefits. In the case of financial incentives, costs are incurred only when foreigners decide to actually enter the country, so that authorities can point to tangible results of their policies. In the case of fiscal incentives, the costs – in terms of forgone tax revenues – often occur later, and will not affect the current budget. Moreover, tax preferences are hard to criticize even in the long run, since there might not have been any tax base at all without the preferences.

[3] In addition, there are costs because subsidization invites rent seeking. For instance, tax holidays and tax breaks may appear to be simple and innocuous forms of incentives, but are likely to lead to transfer pricing and other distortions as firms try to shift as many transactions as possible to the activity with tax preferences, or set up new firms as the tax preferences of existing firms expire.

The question suggested by these comments is obvious: are there any policy alternatives to unregulated subsidization of foreign investment?

3. Policy alternatives

The policy problems with FDI incentives are in many ways similar to those discussed in the trade policy debate. In the same way as incentives may be politically attractive in the short run but costly in the long run, protectionism also promotes local employment and production in the short run at a high long-run cost. In fact, several authors have drawn parallels between trade barriers and international investment subsidies, noting, for example, that it is possible to calculate tariff equivalents for each FDI subsidy (Bond and Guisinger, 1985; Huizinga, 1991). Both policy areas are also characterized by coordination problems, where no country gains from unilateral liberalization unless it expects others to follow. In the trade area, the path away from "beggar-thy-neighbour" policies has been multilateral negotiations where trade liberalization is coordinated across countries. It is clear that a similar solution would be first-best also in FDI policy, in particular at the regional level, where competition is most fierce.

However, although multilateral agreements – for instance, WTO's Agreements on Subsidies and Countervailing Measures (SCMs) and Trade-Related Investment Measures (TRIMs) – include clauses on incentives and investment rules, they do little to improve the bargaining position of host countries. In fact, the TRIMs Agreement actually tilts the playing field in favour of multinational firms. It prohibits measures that were formerly used to promote positive effects of FDI, such as local content requirements, but does not limit the scope for subsidy-based competition.[4] More comprehensive

[4] As noted earlier, measures such as local content requirements may also have motivated FDI incentives in some instances. However, the discussion about restricting TRIMs has rarely recognized that removing TRIMs removes an important motive for FDI incentives.

regulation of FDI incentives is found only in advanced regional integration agreements such as NAFTA and the EU, where extensive market integration has made it necessary to harmonize incentive policies as well. Judging from the failure of the OECD's Multilateral Agreement on Investment a few years ago, there appears to be little scope for any broad initiatives in this area at present.

In the absence of multilateral agreements on investment, it is therefore likely that many countries will continue subsidizing FDI. How should FDI incentives then be designed?

The most important argument against investment incentives focusing exclusively on foreign firms is based on the conclusion that spillovers are not automatic, but depends crucially on the conditions for local firms. The potential for spillovers is not likely to be realized unless local firms have the ability and motivation to learn from foreign TNCs and to invest in new technology. Consequently, investment incentives aimed at increasing the potential for spillovers may be inefficient unless they are complemented with measures to improve the local learning capability and to maintain a competitive local business environment.

This suggests first and foremost that the incentives should be rules-based and available on equal terms to all investors irrespective of industry and nationality of investor, rather than based on discretionary decisions. The motive for supporting foreign investors – including existing investors that may consider expanding their activities – is to equalize social and private returns to investment. But there is a difference between social and private returns only if local firms are actually able to absorb some of the potential spillover benefits, and this does not occur automatically. Hence, to justify FDI incentives, there is a reason to simultaneously support local firms in strengthening their capacity to absorb foreign technology and skills.

Moreover, the incentives should ideally not be of an *ex ante* type that is granted and paid out prior to the investment, but should instead promote those activities that create the strongest potential for spillovers. In particular, these include education, training, and research and development (R&D) activities, as well as linkages between foreign and local firms. An advantage of performance-based incentives is that they may affect the entire stock of investments, rather than just the flow of new investment. Measures focusing on training and R&D are also compatible with the WTO Agreement on SCMs. Given their broad scope, the investment incentives in question should be considered part of the economy's innovation and growth policies rather than a policy area that is only of relevance for foreign investors. At the same time, it is possible that the kinds of incentives discussed here may replace many of the performance requirements that have hitherto focused on foreign investors.

In addition to investment incentives of the type discussed above, Governments should consider their efforts to modernize infrastructure, raise the level of education and labour skills, and improve the overall business climate as parts of their investment promotion policy. As noted earlier, these are important components of the economic fundamentals that determine the location of FDI. As well as attracting FDI and facilitating the realization of spillovers, these policies will promote growth and development of local industry. This, after all, is one of the ultimate goals of government intervention in general.

4. Concluding remarks

FDI can play an important role in raising a country's technological level and promoting economic growth. Many countries are therefore actively trying to attract foreign investors with various incentives and subsidies. However, designing efficient incentive programmes is a complex task, and the competition between host Governments trying to attract FDI adds to the challenge, as it tends to shift profits and welfare from

the host countries to foreign multinationals. A first-best solution for FDI incentive policy may therefore be multilateral policy coordination to set the "rules of the game", in the same way as GATT/WTO has defined the rules for international trade policy. A second-best solution may be to consider the investment incentive packages as part of the country's overall industrial policy, and to make support programmes available to all investors, foreign as well as local. The reason is that the expected positive spillover effects of FDI on the local economy depend on the ability and motivation of local firms to learn from foreign TNCs and to invest in new technology. Incentives could also be designed to support activities that create a potential for spillovers and learning, such as training and R&D. This type of incentive programme could to some extent substitute for explicit performance requirements for foreign firms, which are likely to cause much more friction in international negotiations.

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Host country policies on FDI with particular reference to developing countries – A brief commentary

Kwasi Abeasi

1. Introduction

At the recent Conference on Financing for Development held in Monterrey, Mexico, in March 2002, a consensus was reached that developing countries need *more trade* under fair conditions (such as fair prices, more access to markets, fewer subsidies, etc.) than *aid*. This is because studies conducted by several researchers had shown that if trade barriers were lifted and fair prices paid, developing countries could generate over $300 billion annually. Clearly, when one bears in mind the sum of only $50 to $60 billion required by the New Partnership for Africa's Development programme per annum, it is obvious that there should be more trade for developing countries if the world is to make any headway in development and in combating poverty.

But how can developing countries have more trade except by expanding their production base? And how can we expand the production base except through increased investments, especially foreign direct investment (FDI). Thus the need for developing countries to attract FDI is straightforward and not in question. Indeed, the consensus of economic literature and experiences of nations worldwide is that FDI is a strong impetus to growth in trade, gross domestic product and social welfare. What is perhaps less clear is whether domestic investment can take the lead and then attract FDI.

Historically, the overwhelming majority of investment in both developed and developing countries has been and continues to be domestic. Yet many developing countries, including

Ghana, have difficulty in stimulating local investment because of very low domestic saving rates.

FDI plays a significant role in the development process of host economies because it acts as a vehicle for obtaining foreign technology, knowledge, managerial skills and capital. Governments therefore are expected to determine what role they want FDI to play in the development process of their economies and then design their FDI policies accordingly. Ghana, like most developing countries, is so heavily dependent on foreign investment, especially donor country investments, that our policies have tended to overliberalize our economy in response to the prompting of donors and are heavily tilted towards attracting FDI to the neglect sometimes of promoting domestic investment. The major factors that are known to affect the chances of developing countries in attracting FDI and benefiting from it include a good macroeconomic environment, stability (political, social and economic), an effective legal framework and the rule of law, and the capacity of the host economy and its domestic enterprises to absorb benefits from FDI.

2. Macroeconomic policies

Good macroeconomic policies are usually the end result of good governance strategies, which ensure the putting in place of prudent and sound practices in government spending, the rule of law, adequate credit to the private sector and reward for work done. Our experiences in Ghana indicate that as we have moved forward in our search for good macroeconomic performance, so have our efforts to attract FDI improved and yielded results. You cannot expect to attract or benefit from FDI if your macroeconomic fundamentals are not right. Although many of us from the developing countries have in the past thought that incentives are the thing that drives FDI, we are now wise to the fact that incentives are only the "icing on the cake" and that the macro indicators are the things to watch.

The difficulty in keeping the macro economy in good shape, however, is the fact that most of the factors that influence it greatly are external to the local economy and therefore difficult for the host country to control. Particularly for developing countries which rely on commodities, such as Ghana, this is extremely difficult and policies have to take that into account. We in Ghana, for instance, have had to adopt policies that will shift us from our overdependence on a single or a few commodities such as cocoa, timber and gold. We have designed policies that encourage the development and promotion of non-traditional exports.

In our previous strategy for attracting FDI our whole effort was directed towards the foreign targets with little attention to the domestic enterprises. In our new approach and building on our past experiences, we are now paying attention to domestic enterprise capacity-building and mobilization of domestic resources to partner FDI.

The theme and thrust for the *World Investment Report 2001* was the promoting of linkages, and the use of linkages was identified as a strategy for attracting investments. Intensified competition has forced firms to specialize more in their core competencies and to rely more heavily on links with external partners (suppliers, buyers or even competitors) than in the past. This has led to the need for industrial clusters, which are playing an increasing role in economic activity, particularly in technology-intensive activity. We therefore tried to use the cluster approach in Ghana. With the help of the United Nations Industrial Development Organization we set up clusters in the woodworking, construction and marine sectors, but did not have much success in properly organizing these simply because of the individualistic nature of our people. However, we are still working on the linkages concept, for we know that linkages can transmit knowledge and skills between linked firms. A dense network of linkages can promote production efficiency, productivity growth, technological and managerial capabilities, and market diversification for the firms involved. Of course, for the host economy linkages can stimulate economic activity and,

where local inputs substitute for imported ones, benefit the balance of payments.

3. Political stability and safety of investments

Another area of concern with regard to FDI is the political stability of not only the host country in question but also the whole region. FDI normally goes where there is relative political stability. Most developing countries, especially in Africa, have a major problem in satisfying this condition.

Even though Ghana has enjoyed political stability and relative peace for a long time, the instability in the subregion has had a serious negative effect on our efforts. This is why our new Government is taking such an active role in the resolution of conflicts in the surrounding countries. Through membership of the World Bank's Multinational Investment Guarantee Agency, developing countries such as Ghana bring some level of comfort to investors as to the safety of their investments.

Additional measures such as the signing of bilateral investment treaties (BITs), double taxation treaties and investment promotion and protection agreements (IPPAs) all contribute to increasing the security and safety of investments, and should therefore be part of the policies of the host country aimed at making the environment investor-friendly. Ghana has signed several IPPAs and BITs with various countries. The problem has been with the ratification of these treaties and agreements. The ratification process seems to be too slow; however, we are however taking steps to rectify this.

4. Legal framework and the rule of law

The general observance of the rule of law and a good legal framework that ensures prompt and equitable resolution of commercial disputes are prerequisites for attracting and benefiting from FDI. With this in mind, most developing

countries strive to improve their legal environment. Unfortunately, however, since legal reform everywhere is rather slow, the current legal framework in most developing countries is not attractive to investors. For Ghana in particular, a great deal of work has been done in this area with the establishment of the "fast track" courts and the commercial courts that are to be established soon. Alternative dispute resolution mechanisms have also been introduced, notably the Ghana Arbitration Centre and the American Chamber of Commerce's Mediation Centre. The Government's declaration of a golden age of business has brought in its wake an obligation for all stakeholders to ensure a new attitude towards the rule of law and good corporate governance.

5. General comments

For most developing countries the significant role that FDI can play in the development process makes it imperative that host Governments design smart policies and intervention mechanisms to maximize the benefits of FDI and minimize their negative effects. At the same time "binding commitments" in international agreements to which the host country is a signatory may limit the policy autonomy of the Government to develop policies that will enhance the host country's development process.

Ghana has over time tried, tested and developed various policy options for the purpose of attracting FDI. The Government has, particularly in recent years, been pursuing policies aimed at enhancing the attractiveness of the business environment in the area of politics and macroeconomic stability, and is currently engaged in improving infrastructure and human resources, trade policy, and science and technology policies, including a major review of labour laws that are applicable nationwide or specific to various sectors of the economy.

In the past poor management of the macroeconomic environment created cumulative difficulties for enterprises and has therefore necessitated that the Government formulate policies geared towards the development of enterprise capabilities, especially revamping domestic distressed industry and small and medium-sized enterprises.

Very recently, UNCTAD has been instrumental in helping the Ghana Investment Promotion Centre (GIPC), together with other stakeholders, to review policies that include those which consist of rules and regulations governing the establishment and operations of foreign investors and treatment accorded them in the various sectors in which they operate. The GIPC as a government agency to promote and coordinate investment activities in the country has pursued various strategies over the years.

Although there is an awareness of the risks involved in these strategies, they still offer a viable chance of attracting investment. The Government, led by the President, has vigorously embarked on extensive investment image-building tours that have enhanced the location status of Ghana as an investment destination in West Africa. The approach has been to enhance the environmental opportunities of Ghana as an industrial hub of West Africa for the subregional market.

Some of the international-investment-related agreements, especially those supported by WTO, constitute hindrances to the drive towards attracting the "industrial tigers" to some of the developing countries. This relates particularly to those "host country operational measures" categorized as "red-light", which are explicitly prohibited by the WTO. Much as we have tried to bring the rules and regulations up to acceptable international standards, it may be found that for the general balancing equation in the country and for the performance requirements of a particular project, especially the Free Trade Zone (FTZ), it is important to introduce "export controls" into the regulations. In Ghana, for example, the FTZ laws specify a minimum export level of 70 per cent of produce.

The Economic Community of West African States (ECOWAS) treaties provide the first "yellow-light" host country operational measures that affect our subregion. One principal provision in the ECOWAS treaties is the free movement of people throughout the region. This ideal situation is yet to have full implementation among the countries concerned. There have been recent efforts, which stand to yield good results, to remove some of the obstacles to the movement of goods from country to country. It is essentially in this endeavour that Ghana seeks to position itself as the economic hub of the subregion. "Green-light" HCOMs have been very much liberalized. GIPC Act 478 permits foreign participation in all sectors of the economy except in petty trading and barber shop operations. The review of Act 478, which is ongoing, aims at improving upon rules and regulations for the establishment and functioning of FDI operators. The law specifically prohibits expropriation of properties of foreign investors and the Constitution of the Republic guarantees transfer of profits from operations and for repayment of loans.

Ghana is a signatory to the ACP–EU Cotonou Agreement and the Lomé Convention, which impose some limitations along the lines of WTO agreements on investment related trade policies. Specifically, the issue of banana exports has been a source of concern until recent developments in the EU market, which allowed exports of bananas from Ghana; even so, the quota is still a problem. So, do some multilateral agreements enforce mandatory requirements on exports of percentages of goods and services, percentage of domestic content in production, volume or value of imports to volume or value of export, or the amount of foreign inflows associated with investments? These agreements sometimes constitute impediments to effective promotion of FDI in the developing countries.

FDI has become a worldwide phenomenon in the development process. Its benefits are many, but to attract it has become a problem for many developing countries. Sub-Saharan Africa in particular has not been a major beneficiary of FDI. For countries in the region and similar areas the multiple policy strategies adopted by government to attract FDI are sometimes not prioritized efficiently owing to the many issues that need to be addressed simultaneously. To generate synergy between FDI and domestic enterprise, we need to build the capacity of domestic enterprises to partner the FDI.

The effectiveness of host country policy measures in attracting FDI: The case of Hungary

Magdolna Sass

1. Introduction

Hungary is a country that has, to a certain degree, succeeded in achieving certain economic and development goals by using active foreign direct investment (FDI) policies. However, its FDI policy became more and more constrained during the 1990s. Hungary's transition process started in 1989. At the beginning of the 1990s, the country had a negligible stock of inward FDI. At the end of 2002, the stock of FDI exceeded $30 billion, taking into account-reinvested earnings, which do not form part of official FDI statistics. In per capita terms, Hungary is still among the leading host countries of FDI in Central and Eastern Europe.

As for the sources of FDI, most of the leading investor countries are European Union (EU) member countries: Germany, the Netherlands and Austria. The United States can also be found among the major sources. About one third of the FDI stock is in manufacturing. Real estate, financial services and trade are the most important among the service industries. Between one quarter and one third of the total stock of investment is estimated to be greenfield. Less than 25 per cent of the overall FDI inflow is related to privatization (estimation based on Kalotay and Hunya, 2000). The majority of the investments target the domestic market (including FDI in services). In manufacturing about one fourth of the FDI is estimated to be export-oriented (estimation based on Élteto and Sass, 1998).

2. FDI policies

Since the beginning of 1990s, two periods in Hungary's FDI policies can be distinguished: the first lasted until around 1996, and the second from 1996 until present. The two periods differ in terms of economic and political circumstances, goals, FDI policies and/or the (in some cases unintentional) impact of other policies on FDI inflows.

The first period was characterized by high non-commercial risk and negative economic growth. As a former socialist economy, Hungary suffered from a lack of capital, and needed considerable reform and restructuring. Like Poland in the same region, Hungary started transformation with a high foreign debt burden. During that period, policies aimed at attracting as much FDI as possible, mainly through privatization, in the framework of which emphasis was put on selling for cash. This priority can be explained by the high foreign debt burden. A special feature of the policy was to attract a few blue-chip companies through special, individual bargains, bearing in mind that FDI itself can attract further FDI. Indeed, the arrival of some well-known investors is often the best advertisement for a country. Because of the fragile state of the economy and because of the specificities of transition, shorter-term economic considerations dominated. Attraction of FDI then consisted mainly in the liberalization of capital flows and the creation of a legal framework for FDI. These measures were adopted quickly in a regional comparison. The incentive system was made very generous. In some cases (notably large projects) individual bargaining took place, making the system relatively opaque. However, State aid given to large investors was “channelled” through existing schemes. In a few cases, monopoly positions or closed markets were provided to foreign investors.

During the second period, the economic environment had become more stable and gross domestic product had started to show positive growth (even at high rates until 2001). Most of the key market economy institutions had been put in place and

were functioning. A relatively high stock of FDI had accumulated and a number of blue-chip investors had been attracted. In terms of policy aims, longer-term economic objectives grew more important and the government policy aimed not only at attracting FDI, but also at increasing its benefits. FDI policy was used to attain other policy goals too (for example, in the context of industrial policy, regional policy, trade policy, research and development (R&D) policy, and labour policy). The main objective of the FDI policy was to attract export-oriented large investments (in manufacturing), and specifically to increase backward linkages with local companies. Correspondingly, the incentive system was made less generous, more normative and more transparent. Its most important elements were fiscal (tax allowances) and other (industrial free-trade zones) incentives. However, it gave preference to large investments (the number of enterprises enjoying the greatest benefits is less than 50). In order to reap more benefits from FDI, more performance requirements were introduced as conditions for the incentive (for example, diverting FDI flows to certain regions, sectors and activities, employment, sales growth). A special programme was initiated to increase domestic suppliers' share in value added mainly by way of offering preferential credits and technical assistance for potential Hungarian suppliers.

Four elements of Hungary's FDI policy were especially important: the overall economic (and political) environment, the privatization policy, tax allowances and the industrial free-trade zones.

3. The economic environment

As far as stabilization and the establishment of the institutional and legal framework of the market economy are concerned, Hungary has always been among the leading countries in the region. According to the measure used in the European Bank for Reconstruction and Development's

Transition Reports (which assess not only quantitative, but also qualitative achievements in terms of the formation of a functioning and stable market economy), Hungary has always been among the top two or three performers in the region.

4. Privatization policy

In Hungary, a substantial amount of FDI has been attracted through strategic privatization projects even in a regional comparison. Since the start of that process, cash sales have prevailed over other privatization methods. This was considered the best way to involve responsible (strategic) investors and raise money for a debt-ridden economy in a relatively short period of time. Between 1991 and 1999, about one third of total FDI inflows were connected with privatization. However, after 1998, the share of privatization-related FDI has become negligible in total inflows. Even in an international comparison, Hungary has privatized a very large share of its public sector. Privatization contracts in many cases contained agreements on issues belonging otherwise to other policy categories, such as performance requirements concerning the privatized company's exports, employment, production and so forth for a predetermined period of time. There were two main problems connected with privatization. First, in some cases, monopoly position or closed markets were privatized in order to make the target enterprise more attractive to a foreign investor. Second, in some cases, lower prices could only be achieved because of the urgent cash needs of the economy. At the same time, sales to foreigners and thus a greater inflow of FDI provided Hungary with a "first-mover" advantage, which could partly explain the larger inflow of non-privatization FDI as well.

5. Tax incentives

In both periods, a substantial part of the Hungarian FDI incentive system was made up of tax incentives. While in a regional comparison they were generous at the beginning of the

1990s, their generosity decreased substantially by the end of the decade (e.g. an increased minimum investment requirement considerably reduced the number of companies that qualified for it). Minimum investment requirements are now about ten times higher in Hungary than in its most important competitors. Tax allowances have been used to attract large companies (high minimum investment requirement) and to divert FDI flows to less developed locations (lower minimum investment requirements combined with other incentives) and to a lesser extent to divert FDI to selected sectors or activities, for example manufacturing or export or R&D activities. Company questionnaires and analysis of FDI projects show that tax allowances particularly helped to realize the first goal. Large companies, which received tax allowances, selected that incentive (together with the overall level of taxes) as one of the main factors in their investment decisions.[1]

From the tax declarations of companies, it can be seen that performance requirements connected with incentives aimed at attracting FDI to various industries and activities worked only to a limited extent. This is also true of incentives for investment in less developed areas. There are only a few, certainly not large-scale, projects in these areas (Antalóczy and Sass, 2001a).

6. Industrial free-trade zones

A special element in Hungary's FDI policy is the industrial free-trade zones (IFTZs) (Antalóczy and Sass, 2001b). The regulation concerning IFTZs was introduced in 1982 with the objective of attracting export-oriented, high-technology FDI to Hungary. Another objective was to integrate the companies operating in industrial free-trade zones as much as possible into the host economy, and eliminate the risk of a dual economy evolving. Hungary's regulation of IFTZs is unique. Any

[1] At the end of the 1990s, the profit tax was reduced to an internationally competitive level of 18 per cent, the lowest in the region. Foreign affiliates found that factor also very important as an investment-attracting factor.

company may set up its own zone without geographical restrictions of any kind under licence from the customs and finance authorities. IFTZs are considered extraterritorial for purposes of duties, foreign exchange and other legislation. Goods and means of production (excluding building and auxiliary material) are not subject to customs duties and value-added tax. This regulation is especially attractive for (export-oriented) greenfield investors. Since 1996, contributions in kind can be imported duty- and VAT-free only for investments made in IFTZs. For these large projects, paying the duties and VAT would make great differences in costs. For assembly companies using only local labour, it enables them to bring in high-value equipment free of duty for their own use.

Starting in 1990, more and more IFTZs have been established in Hungary. First, a number of TNCs carried out greenfield investment in Hungary in an IFTZ (for example, General Motors, Suzuki and Philips). Subsequently, their competitors or suppliers followed them and established their Hungarian affiliates in an IFTZ (Ford, Audi, IBM, Nokia, Lear Corp., United Technologies, Sony and Zollner) as well as a few other companies, which identified Central Europe as an attractive investment location around that time (e.g. Benetton).

At present, there are more than 100 IFTZs in Hungary, about 70–75 of which were established through greenfield investment. The share of foreign capital exceeds 90 per cent in the total share capital of IFTZ companies. However, links between IFTZs and local firms remain limited.

7. The effectiveness of FDI policies/incentives

The evaluation of the effectiveness of FDI incentives is made difficult by the fact that detailed cost-benefit analyses do not exist. When evaluating, a distinction is made below between the efficiency of the incentives with regard to the objectives sought. Let us first consider the inflow of FDI.

In regional comparison, there was a high inflow of FDI in the first period, which was due mainly to the good economic environment in regional comparison and to the privatization method. In the second period, the improved economic environment, reinvestments and some of the incentives explain the relatively high inflows of FDI. If reinvested earnings are taken into account, Hungary remains one of the leading FDI recipients in the region.[2]

Second, to what extent has the country benefited from the inflow of FDI – that is, do the social returns connected with FDI exceed the cost of the incentives? There are no detailed analyses, but case studies and anecdotal evidence may be indicative.

In the first period, as already noted, mainly privatization-related FDI dominated inflows. A specificity characterizing economies in transition is that capacities acquired by foreign investors in many cases are obsolete and need complete restructuring. In such cases, foreign investors tend to carry out changes and developments, which are comparable to those of greenfield investments. In Hungary, such efforts raised the investment rate, provided additional capital, reduced the social costs of transition and helped to bridge the foreign exchange gap.

Owing to the composition of FDI incentives and the special role of the IFTZs, many greenfield, export-oriented companies were established in the second period. They have played a special role in the Hungarian economy. The quick growth of export and the changes in its production structure towards higher value-added can be mainly attributed to TNCs' greenfield investments in IFTZs. They give dynamism to exports, and change the export structure towards higher value-

[2] According to a questionnaire survey (Antalóczy and Sass, 2002), in the second period the overall state of the economy in regional comparison, the incentive system and the overall level of taxes (especially profit tax) were the most important motivating factors from the point of view of the investors.

added and higher-technology products. However, at present these companies have limited linkages to the host economy, and thus their effects on the overall economic performance is also limited. Nevertheless, there is a sign that a gradual building up of local supplier networks is going on and there is an increase in local value added and in the use of more skilled local labour. Meanwhile, some of them left the country after the incentives expired. On the other hand, greenfield investments in industrial free-trade zones encouraged their traditional suppliers to follow them to Hungary. These companies set up a greenfield company or established a joint venture in IFTZs as well, adding to the stock of FDI in Hungary.

According to the data on the composition of FDI, performance requirements had only a limited impact on the inflow. Only a few companies invested in less developed regions or in R&D activities or in preferred industries. As for the cost of incentives, Antalóczy and Sass (2002) analysed the budgetary revenues received from and the forgone earnings due to the tax allowances of the biggest investors. According to that study, the "balance" is slightly negative from a budgetary point of view.

8. International agreements affecting the use of FDI policies

Hungary is a candidate for membership of the EU. FDI incentive policies have to be changed in order to become compatible with EU regulations. This involves the elimination of some elements of FDI policy, and a change of emphasis from fiscal to financial and other incentives, and considerably limits Hungarian FDI policy's room for manoeuvre. One of the most important FDI–attracting regulations, that of the industrial free trade zones will, for example, have to be replaced by a more general system of industrial parks.

On the other hand, joining the European Union will have many positive impacts. To name but a few, Hungary will

become part of a larger, more or less unified market, which in itself is an important attracting factor from the point of view of FDI. Hungary's eventual membership of the euro area can make Hungary even more attractive in this regard. Moreover, as far as FDI policies are concerned, inside the European Union the so-called incentive competition will be much more constrained. New members will be on a more “equal footing” as far as the use of FDI incentives is concerned. There are many limitations and strict and enforced regulations inside the EU, which will now be extended to the new members.

9. Conclusion

To conclude, Hungary was one of the leading countries among the economies in transition in attracting FDI in the 1990s. The Government's FDI policy played an important role in shaping the capital inflows. The most important factors, explaining Hungary’s position in attracting FDI are set out below.

Hungary's overall economic environment, compared with that of other countries in the region, was favourable for FDI in terms of its heritage, its relative closeness to market economies, its privatization policy and its ability to build up the market economy institutions relatively quickly. The economic environment and the approach to foreign investors proved to be relatively stable and predictable compared with those of other countries in the region. Being the first in the region to open up to FDI implied a first mover advantage. All these factors resulted in a relatively quick accumulation of FDI, which led to further inflows by foreign service-providers, suppliers to existing investors, competitors of investors, and so on.

Joining the European Union will result in completely new conditions and circumstances for FDI policy. As a consequence, Hungary will be in a position which will be partly more attractive (less and more regulated regional “incentive

competition”), and partly less so (Hungary loses some of its special incentives, especially the IFTZ regulation) compared with the pre-accession period. By now, the lower level of inflows, the departure of some footloose projects and a stubbornly low level of linkages with the domestic economy indicate that FDI policy may have to be adjusted.

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Use and effectiveness of performance requirements: What can be learnt from the experiences of developed and developing countries?

Nagesh Kumar

1. Introduction

FDI usually flows as a bundle of resources including, besides capital, production technology, organizational and managerial skills, marketing know-how, and even market access through the marketing networks of transnational corporations (TNCs) that undertake FDI. Therefore, developing countries seek FDI to benefit from these resources of TNCs in their industrialization and development. They also expect to benefit from knowledge spillovers and other favourable externalities from FDI. However, there is considerable variation in the "quality" of FDI inflows and not all of them benefit their host countries equally. The recent empirical studies have shown that knowledge spillovers may not occur, particularly in developing countries, and domestic enterprises may actually be adversely affected (Haddad and Harrison, 1993; Kokko et al. 1996; Aitken and Harrison, 1999; De Mello, 1999; Xu, 2000). Recent empirical literature has also presented evidence that by crowding out domestic investment, FDI in some cases may thus be immiserizing (Fry 1992; Agosin and Mayer, 2000; Kumar and Pradhan, 2002).

There could also be possibilities of divergence between TNC interests and the host country's developmental objectives arising from their strategy to pursue the objective of global profit maximization. In order to maximize the global profits, the interests of certain affiliates may be compromised and sourcing decisions may not be taken on the basis of efficiency considerations alone. There is also evidence of widespread manipulation of transfer prices in intra-firm trade.

Given the possibility of conflict of interests, performance requirements have been employed by host Governments, among other policy instruments (such as trade policy, screening mechanisms and incentives), to maximize the contribution of FDI to the process of development. Objectives include deepening of the domestic industrial base, generation of employment and local linkages, development of export capability and improvement of balance of payments, and development of local technological capability through transfer and diffusion of technology.

Besides helping in industrial development and managing the balance-of-payments objectives, trade-related investment measures (TRIMs) have been employed by host countries (so it has been argued) to deal with the restrictive business practices pursued by TNCs (Puri and Brusick, 1989). For instance, TNCs may engage in importing more in order to provide markets to related companies or may indulge in manipulation of transfer prices of imports from related sources to transfer profits. Local content requirements (LCRs) or foreign exchange neutrality could moderate the effect of restrictive business practices.

Performance requirements have been employed (in developed countries) to deal with four broad types of concerns, namely micro- and macroeconomic impact, in income distribution issues, maintenance of political independence and distribution of power (UNCTAD, 2003, chapter VI). Many Governments – in developed as well as developing countries – have extensively imposed performance regulations on FDI at the time of entry in order to pattern their operations in consonance with the country's development objectives (see Guisinger et al., 1985; UNCTC, 1991; UNCTAD, 2001).

UNCTAD (2001) lists different types of performance requirements or host country operational measures (HCOMs). The most common performance requirements have been the following:

- Local content requirements in different forms;
- Export performance requirements in different forms;
- Indirect export performance requirements in the form of trade balancing or dividend balancing, or foreign exchange neutrality requirements;
- Requirement to establish a joint venture with domestic participation or for minimum level of domestic equity participation;
- Employment performance requirements;
- Requirement to transfer technology, production processes or other proprietary knowledge; and
- Research and development requirements.

This paper reviews the literature on the incidence, effectiveness and other implications of performance requirements for development. Section 2 summarizes the evidence on the incidence of performance requirements in different countries and sectors. Section 3 reviews the evidence on effectiveness of performance requirements in meeting their stated policy objectives. Section 4 examines the evidence on the effect of performance requirements on the magnitude of FDI inflows, and section 5 concludes the paper with some policy remarks.

2. Incidence of performance requirements

The incidence of performance requirements has varied across countries, depending on their level of development, their endowments of natural and other resources, market size and development strategy, among other factors. Among the developed countries, Australia, Canada, France and Japan have made extensive use of performance requirements. Australia (and New Zealand) imposed 50 per cent domestic ownership requirements in natural resource projects, and also employed an offsets policy under which larger government contracts required

new domestic activity of 30 per cent of their import content. Canada enacted a Foreign Investment Review Act in the early 1970s under which an extensive set of performance requirements (called undertakings) were imposed to ensure that "significant benefit" was reaped by Canada from the operations of FDI. Norway and Sweden also imposed performance requirements for natural resource concessions. France has imposed an extensive set of performance requirements on foreign investors, depending on the nationality of the investor, economic growth effects, including employment, regional balance and promotion of local R&D; competition with French enterprises and balance of payments etc. Japan also imposed performance requirements at the time of approvals, depending on the contribution to technology development, export or import substitution, competition with Japanese industry and 50 per cent foreign ownership, and required the president of a joint venture to be a Japanese. In the United States, the Committee on Foreign Investments in the United States (CFIUS) under the Exon-Florio Amendment, has rejected some proposed takeovers and also at times imposed what amounts to performance requirements (UNCTAD, 2003, chapter VI).

Among the specific types of performance requirements, local content requirements have been employed by most of the developed countries and developing countries at one time or other (see Sercovich, 1998; Low and Subramanian, 1995; and WTO/UNCTAD, 2001 for illustrations). In particular, Governments have employed local content requirements in the auto industry to promote backward integration and localization of production of value added. Many of the developed countries have imposed local content requirements in the auto industry until recently. For instance, Italy has imposed a 75 per cent local content on Mitsubishi Pajero, the United States has imposed a 75 per cent rule on Toyota Camry, and the United Kingdom a 90 per cent rule on Nissan Primera (Sercovich, 1998). Australia imposed a 85 per cent local content rule on motor vehicles until 1989 (Pursell, 1999).

Among developing countries too a large number of countries have evolved policy regimes containing performance requirements (Low and Subramanian, 1995; WTO/UNCTAD, 2001). The most prominent performance requirements have been the local content requirement imposed on the automobile industry, as is clear from table 1. However, local content requirements for other sectors and other types of performance requirements have also been imposed by a number of developing countries. A number of developing countries, such as Argentina, Colombia, Malaysia, Mexico, Pakistan, the Philippines, Thailand and Romania have sought extensions of the transition period under Article 5.2 until December 2003.

Table 1. Incidence of broad types of performance requirements among developing countries

Type of requirements	Countries
Local content in auto Industry	Argentina, Brazil, China, Chile, Colombia, Ecuador, India, Indonesia, Malaysia, Mexico, Philippines, Republic of Korea, South Africa, Taiwan, Province of China, Thailand, Uruguay and Venezuela.
Local content in other industries and other performance requirements	Barbados, Bolivia, Chile, China, Costa Rica, Cyprus, Colombia, Dominican Republic, Egypt, India, Indonesia, Malaysia, Mexico, Nigeria, Pakistan, Peru, Philippines, Republic of Korea, South Africa and Thailand.

Source: based on notifications under TRIMs, and WTO/UNCTAD (2001).

Over time the incidence of performance requirements has declined for a number of reasons, including:

- Normal phase-out with the achievement of developmental objectives (as in developed and middle-income countries);
- Increasing competition for FDI inflows;

- Phase-out under provisions of the TRIMs Agreement; and
- Formation of regional trading blocs such as European Union (EU) and the North American Free Trade Area (NAFTA).

In the developed world, in view of the TRIMs Agreement under the Uruguay Round, there has been a trend towards the replacement of performance requirements by trade policy measures that achieve objectives similar to those of performance requirements but are consistent with the provisions of TRIMs. These include rules of origin, screw-driver regulations, voluntary export restraints and anti-dumping (Belderbos, 1997; Moran, 1998; UNCTAD, 2003, chapter VI). The European Union countries have extensively used the screw-driver regulations which are in effect like local content regulations to deepen the local commitment of Japanese corporations in consumer goods industries in the past. Even currently the industrialized countries, especially the EU and NAFTA member countries, taking advantage of regional trade agreement (RTA) exceptions that are available under Section XXIV of GATT, are effectively using rules of origin to increase domestic value addition. Rules of origin determine the extent of domestic content a product must have in order to qualify as an internal product in a preferential trading agreement. Hence, they have the same effect as the local content requirements. By now considerable evidence is available on the use of rules of origin by EU and NAFTA countries to increase the extent of localization of production by TNCs supplying to them. EU countries have used anti-dumping measures to regulate imports of cars and other products from Japan and South-East Asia, and the United States has aggressively used similar measures in attempting to achieve reciprocity (i.e. "substantially equivalent competitive opportunities") in trade and investment with Japan and other countries (UNCTAD, 2003, chapter VI). In the United States provisions of the Buy American Act have acted as local content requirements (Krugman and Obstfeld, 2000).

3. Effectiveness in meeting objectives

(a) Local content requirements

Local content requirements have been employed by host Governments to deepen the commitment of foreign investors with the host economies and to maximize their contribution to income and employment generation and hence transfer of technology and other externalities.

It has been argued that under conditions of perfect competition, local content requirements reduce host country welfare in the event that the prices of local input are higher than the world prices. Therefore, an increased use of domestic inputs imposes a tax on the foreign producers, giving rise to the need for protection (WTO/UNCTAD, 2001). However, the assumption of perfect competition hardly prevails in real-life situations. For instance, local components required by a TNC may have specifications and designs that are proprietary or patented. Hence, they would not be available in the host country unless the TNC licenses their manufacture to some local vendor and passes on the designs and drawings. There may be other considerations for not licensing local production of components, for example to utilize more fully production capacities created elsewhere in the world. Studies have shown that TNC affiliates in developing countries tend to buy the bulk of their inputs from their parents or other associated suppliers and hence generate few domestic linkages (UNCTAD, 2002; Lipsey, 1998; Manifold, 1997). Local content regulations play a useful role in prompting the TNC to consider licensing the local manufacture of such components, which it may not do otherwise because of such considerations. Local content requirements, therefore, may force TNCs to identify nascent local capabilities and provide them with know-how and technology.

A number of theoretical and empirical studies have shown local content requirements to have welfare-improving and favourable developmental effects for host countries. For instance, Davidson et al. (1985) show within a duopolistic

model that local content and export requirements can increase the host country's welfare and employment at the cost of the source country and world welfare. Balasubramanyam (1991) argues that the dynamic benefits resulting from local content requirements such as the development of local supplier capabilities far outweigh the short-run welfare loses that they may impose. Richardson (1993) shows using a General Equilibrium Model that effective local content requirements will induce foreign firms to increase their own domestic production of the component input and will induce capital flows, thus furthering the industrialization of the host country. Lahiri and Ono (1998) develop a partial equilibrium model of an oligopolistic industry and show that local content requirements imposed on foreign firms increase employment in host countries. Yu and Chao (1998) have shown that local content requirements may be put to good use to improve allocative efficiency and enhance host country welfare.

Among the empirical studies, an analysis of affiliates of Japanese electronics TNCs in 24 countries showed that local content requirements were modestly effective in increasing local content, but not in stimulating procurement from domestic suppliers (Belderbos et al., 2001). A recent detailed empirical analysis of United States and Japanese FDI in a sample of 74 countries in seven branches of manufacturing from 1982 to 1994 found local content requirements to be favouring the localization of TNC affiliates' production in the host countries (see Kumar, 2000, 2002). Therefore, the study argued that local content requirements could be an important means of deepening the commitment of TNCs entering an economy and of generating local value-added, and hence employment and the related spillovers of knowledge.

The case study evidence shows that some countries have built capabilities that have eventually become internationally competitive using local content requirement type policies. Brazil, Mexico and Thailand have built an internationally competitive auto industry by enforcing local content requirements and export performance requirements for foreign

auto TNCs (Moran, 1998). Taiwan has also emerged as a major supplier of auto parts in the world following similar policies (Gee, 1997). Local content requirements do not appear to have been that successful in Indonesia (Okamoto and Sjoholm 2000) or in Chile (UNCTAD, 2003, chapter II). The effectiveness of local content requirements is obviously context-specific and is determined by a number of factors, such as the clarity of objectives, effectiveness of enforcement and monitoring, size of domestic market and other advantages of host countries.

(b) Export performance requirements (direct and indirect)

Export performance requirements have been imposed by host Governments to prompt foreign investors to integrate the affiliates in the host countries in their global/regional production networks and also bring other favourable externalities of export-oriented production.

It is argued that if a firm is able to export competitively, it will do so on its own to maximize its profits. Hence, requiring it to export beyond what is commercially viable will be a loss-making activity (WTO/UNCTAD, 2001). This statement is based on the assumption of perfect competition, which hardly prevails. As argued earlier, TNCs engage in global profit maximization and not maximization of each individual affiliate. They practise market segmentation and product mandating strategies to maximize their global profits. They are known to impose export restrictions on their subsidiaries (Kumar, 2001). Full exploitation of a host country’s potential as an internationally competitive location for export-oriented production may also be prevented by information asymmetry.

Rodrik (1987) argues that in the presence of oligopolistic behaviour and tariff distortions export performance requirements can benefit host countries by reducing payments to foreign owners, reducing output in excess supply and shifting profits to locally owned firms. Greenaway (1991) comes to a similar conclusion. Among the empirical studies a detailed empirical analysis of United States and Japanese FDI in a

sample of 74 countries in seven broad branches of manufacturing over the period from 1982 to 1994 found the export performance requirements to be effective in increasing the export orientation of TNC affiliates to third countries (Kumar 1998, 2002).

Among the case studies, China has successfully pushed foreign enterprises to export through export performance requirements imposed at the time of entry (Rosen, 1999). The proportion of foreign enterprises in manufactured exports steadily increased over the 1990s to 45 per cent. TNC affiliates account for over 80 per cent of China's high-technology exports (UNCTAD, 2002). Malaysia has also succeeded in expanding its manufactured exports with the help of performance requirements especially in electronic components, where it now commands 10 per cent of the world market (UNCTAD, 2003, chapter IV). In Chile too, export performance requirements have been found to be useful in diversifying the country's export base (UNCTAD, 2003, chapter II). Case studies presented on Indian experience have shown that export performance requirements have brought a number of favourable externalities to the host economy in the form of diffusion of new technology through contract farming or establishment of vertical linkages of the domestic auto component manufacturers with the world's major auto producers that are of long-term interest. Furthermore, the fact that exports have continued even beyond mandatory requirements shows that the companies involved have discovered new profit centres through export performance requirements (UNCTAD, 2003, chapter III). Mexico, Brazil and Thailand, as observed earlier, have used export performance requirements successfully for "triggering a burst of export-focused investments in the auto industry (Moran, 1998: pp. 53–62). Furthermore, it has been argued that export performance requirements have prompted TNCs to establish world-scale plants incorporating best-practice technology and have generated significant knowledge spillovers for local firms (ibid).

The success of Thailand in building an internationally competitive auto industry by enforcing local content requirements and other performance requirements (such as export performance requirements) for Japanese auto TNCs has been documented (Nippon, 1999; Damri, 2000; Moran, 1998). Imposition of local content requirements in the 1970s and early 1980s created domestic production capacities, but exports by foreign auto producers remained "practically nil" this being blamed on the "inferior quality" of Thai component producers. However, domestic component enterprises that had emerged thanks to local content requirements launched themselves in international markets by obtaining original equipment manufacturing (OEM) status with external buyers (Moran, 1998: p. 60). In the mid-1980s the Government started imposing export performance requirements on foreign enterprises to push them to export. That prompted the Japanese auto makers to think of integrating Thailand into their global production networks. The development of an internationally competitive auto parts industry in the country also led global auto majors such as GM, Daimler-Chrysler and Ford to announce plans to set up auto plants in the country. Thailand has emerged as South-East Asia's main auto hub with a production capacity of one million vehicles. It exported 1,70,000 vehicles in 2001 – the third largest exporter of automotives in Asia after Japan and the Republic of Korea. Automotive exports earned Baht 154 billion and auto components an additional Baht 60 billion in 2001. Honda and Toyota have added a second shift, with Honda announcing sourcing of Honda City for the Japanese market from Thailand and Toyota making Thailand a global production base for pick-up trucks (*Financial Times*, 6 December 2002).

(c) Joint venture and domestic equity requirements

The joint venture requirements or domestic ownership requirements are employed by host Governments to achieve several possible objectives such as promotion of absorption of knowledge brought in or development of local entrepreneurship, or to enhance the host country's share in the distribution of gains from the productive activity generated by the venture.

The domestic equity requirements have been successful in reducing foreign ownership and still bring more FDI in Australian mining, while the Canadian experience of reducing the high degree of foreign ownership and control in the energy sector did not prove that successful (UNCTAD, 2003, chapter VI). Indian case studies have shown that domestic equity requirements have promoted formation of joint ventures that in turn have generated favourable externalities in the form of substantial local learning and quick absorption of knowledge brought in by the foreign partners (UNCTAD, 2003, chapter III).

Some have expressed the view that domestic equity requirements may adversely affect the extent or quality of technology transfer (Moran, 2001). However, it has been shown that TNCs may not transfer key technologies even to their wholly owned subsidiaries, abroad fearing the risk of dissipation or diffusion through mobility of employees (UNCTAD, 2003, chapter III for a case study). Furthermore, even if the content and the quality of technology transfer are greater in the case of a sole venture than in the case of a joint venture, from the host country point of view the latter may have more desirable externalities in terms of local learning and diffusion of the knowledge transferred.

(d) Technology transfer requirements

The evidence on effectiveness of technology transfer requirements is scarce, and wherever available, does not reveal much success, as in the case of Malaysia (UNCTAD, 2002). The technology transfer requirements have been used in only a few cases. There are problems in enforcing and monitoring these requirements, given the problems in objectively measuring the extent of technology transfer. Furthermore, successful technology transfer is crucially dependent upon the local absorptive capability. It would appear that local content requirements, export obligations and joint venture requirements may be more effective in ensuring technology transfer, albeit in a subtle manner, than the requirements to transfer technology per se.

4. Do performance requirements deter FDI inflows?

It has been argued that imposition of performance requirements may adversely affect the magnitude of inflows by making the conditions of investment appear restrictive. While it would appear plausible that performance requirements may adversely affect the quantum of FDI, the evidence is mixed.

A study by the United States International Trade Commission, based on a survey, reported that performance requirements had only a marginal effect on the location of investment (cited in UNCTC, 1991). An empirical study found performance requirements to have had a significant negative effect on United States investment abroad in 1977 but not in 1982 (Loree and Guisinger, 1995). A more recent empirical study of United States and Japanese FDI in 74 countries in seven branches of manufacturing in 1982, 1989 and 1994 found that performance requirements affected United States FDI adversely but that their effect on Japanese FDI was not significant (Kumar 2000, 2002).

The effect of performance requirements on the investment climate is to be viewed in relation to the potential host country's other advantages. In a country offering a large and expanding domestic market and having other advantages, TNCs may want to invest in spite of performance requirements and other restrictions. For example, China has managed to attract a huge volume of inflows despite stringent performance requirements enforced with respect to exports, ownership and local content (Rosen 1999). Similarly, the Indian auto industry attracted nearly all global auto majors to set up their plants in the country despite many performance requirements imposed on them during the 1990s. Furthermore, even if there is a slight dissuading effect on the magnitude of FDI inflow, the developmental benefits accruing to the host country imposing performance requirements may greatly outweigh the adverse effects on magnitudes.

5. Concluding remarks

To sum up the above discussion, performance requirements have been employed extensively by developed as well as developing countries to improve the quality of FDI and to maximize its contribution to their development. The incidence of performance requirements has decreased over the years because of the broad trend towards liberalization of FDI policy regimes and their natural phasing-out with the achievement of development policy objectives, and in response to the TRIMs Agreement. The incidence in developed countries appears to have declined also because they have evolved new forms of policy interventions to achieve the objectives of performance requirements. Therefore, they continue to use policy measures such as screw-driver regulations, buy-local provisions, anti-dumping and rules of origin, which are in effect like performance requirements.

The evidence presented on the effectiveness of performance requirements is generally mixed. It is quite clear that well-conceived performance requirements with clear objectives and effectively enforced are not only able to meet their objectives but may also bring significant favourable externalities to the host countries. The effectiveness of performance requirements in meeting their policy objectives depends on the clarity of objectives, the policy capability of the Governments, market size, absorptive capacity in terms of skills of the work force and strength of domestic enterprises, and other locational advantages and policies (UNCTAD, 2003, chapter VI). The available evidence does not suggest a significant adverse effect of performance requirements on FDI inflows, which are governed more by the overall economic potential of the host countries.

The above findings have implications for the ongoing discussion on the relevance of performance requirements in the context of the review of the TRIMs Agreement and for the debate on the desirability of a possible multilateral framework

on investment. It is clear that performance requirements serve a useful purpose as development policy tools. Hence, they should continue to be available to countries. Given the importance of performance requirements as instruments of development policy, there is a need to invoke special and differential treatment (SDT) for developing and least developed countries in respect of this. In the TRIMs Agreement developing countries were given, in the name of SDT, a transition period for phasing out TRIMs which was only three years longer than that for developed countries. The vast development gap between developed and developing countries cannot be bridged in three years.

Therefore, developing countries should seek exceptions based on the low level of industrialization at the TRIMs review. Article 5(3) of the Agreement could be amended to provide this exception linked to a per capita manufacturing value-added (MVA) threshold. All the countries with MVA per capita below that threshold level should qualify for exemption from the provisions of the TRIMs Agreement. In that way, the Agreement will have taken care of the development dimension as well as the graduation.

The review of TRIMs should also be used to address other asymmetries present in the TRIMs Agreement. One such asymmetry pertains to its failure to curb trade-related restrictions imposed by TNCs on their subsidiaries that are as trade-distorting as the government-imposed restrictions. Given the trade-distorting effect of these restrictions, developing countries should seek to discipline in the TRIMs Review the restrictive conditions that TNCs impose on their foreign affiliates.

Yet another asymmetry in the TRIMs Agreement is its failure to discipline the investment incentives provided by host Governments to attract FDI inflows. The empirical evidence has shown that these incentives tend to distort the investment patterns much in the same way as export subsidies distort patterns of trade. Industrialized countries have largely indulged

in the incentive wars to attract foreign investments to particular locations and have been offering substantial subsidies to TNCs to attract investments.

Finally, and more importantly, developing countries should resist the attempt by developed countries to expand the list of TRIMs that are proscribed under the Agreement.

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Host country FDI policies and development objectives

Vudayagiri Balasubramanyam

1. Introduction

This brief note attempts to elucidate some issues relating to performance requirements imposed on foreign firms by host countries and their efficacy in promoting development objectives. What are host country development objectives? Are they universal or do they differ from country to country? Some are universal, such as employment, income growth and balance-of-payments stability. Some are specific, such as development of specific regions, promotion of minority interests, and importation of advanced technologies. Some countries accord priority to development of local capabilities designed to preserve national sovereignty. These are countries, now a dwindling group, which pursue import substitution (IS) policies.

Attracting increased volumes of FDI must be tempered with recognition of the efficacy of FDI. Efficacy is much more important than volume. Here again some countries may need to attract increased volumes of FDI, others a relatively low volume but high-quality FDI. Policies, that are universal for attracting and efficiently utilizing FDI must be distinguished from a specific set of policies tailored to suit individual countries. Meanwhile, policies that enhance the efficacy and volume of FDI for the group of developing countries as a whole must be distinguished from policies that set one country against the other.

FDI is, as often noted, a bundle of capital, technology, managerial know-how and marketing skills. While there is a wide-ranging debate on unbundling the bundle, some countries may be able to benefit from unbundling, that is rely on licensing agreements, whilst others may require FDI. The literature on

FDI recognizes a set of factors that facilitate increased flows of FDI and efficient utilization of FDI in the promotion of development objectives that are universal. The most significant of these are:

1. Host countries with sizeable domestic markets, measured by GDP per capita and sustained growth of these markets, measured by growth rates of GDP, attract relatively large volumes of FDI.

2. Resource endowments, including natural resources, and human resources are a factor of importance in the investment decision process of foreign firms.

3. Infrastructure facilities, including transportation and communication networks, are an important determinant of FDI.

4. Macroeconomic stability, signified by stable exchange rates and low rates of inflation, is a significant factor in attracting foreign investment. A stable and transparent policy framework for FDI is attractive to potential investors.

5. Foreign firms place a premium on a distortion-free economic and business environment.

2. General macroeconomic policies

The first of these policies confirms that FDI is a catalyst of development and is most attracted to countries with a threshold level of development and human capital. Market size here should be based on effective demand and not the population size of host countries. Indeed, most of these criteria emphasize macroeconomic polices which promote stability. Apart from exchange rate, monetary and fiscal policies, macroeconomic policies conducive to development include labour legislation and labour training programmes. In addition,

policies such as reservation of production of specific goods to specified sectors may impact on efficient resource allocation and may be counterproductive even in serving the equity objectives they are supposed to promote. Here discrimination may not only be between foreign firms and domestic firms but also between various categories of domestic firms. The example here is India's clothing industry, which until recently has suffered from positive discrimination policies in favour of small-scale industries.

Advocacy of stable macro policies conducive to the promotion of development objectives is easier said than done. Is there an universal set of policies applicable to all of the emerging economies? Should all of them embrace floating rates and liberalize both the current and capital accounts of the balance of payments. In this context it is worth noting the so-called Macro Policy Trilemma facing most countries. Simply put, the trilemma is that countries can pursue two of the following three objectives but not all three: (a) Exchange rate stability (fixed or anchored rates); (b) free capital mobility; and (c) pursuit of autonomous monetary and fiscal policies geared to promoting growth and employment.

The received wisdom now is that the trilemma can be mitigated if not avoided by adopting a floating rate and allowing for capital mobility. Freed of the obligation to defend the exchange rate, countries can pursue policy objectives and allow for capital flows. These scenarios club portfolio capital flows with FDI. The exchange rate is a determinant of FDI flows in so far as investors are concerned with effects of exchange rate fluctuations on the repatriation of profits. This does not, however, suggest that a fixed rate system is necessarily conducive to inflows of FDI. Exchange rates could be stable under a floating rate in the sense that their course can be predicted with a certain degree of confidence provided host countries follow appropriate fiscal and monetary policies, appropriate in the sense that the scope of the objectives they are to serve are well defined and they complement micro policies such as promotion of human capital and infrastructure in the economy. This, however, is an issue for further research.

3. Trade-balancing requirements

It is, however, worth noting in this context that trade-balancing requirements (red-light HCOMs) imposed on foreign firms by some developing countries arise because of a narrow view of the balance of payments and a failure to recognize that trade balance is a function of overall economic policy. Any investment, which is socially productive, is bound to have a positive impact on the balance of payments irrespective of whether or not its import contents exceed its exports. Socially productive investments would generate linkages in the economy and build up the productive potential of the economy and contribute to the overall trade balance of the country.

4. Transparency of policies

Yet another significant determinant of FDI flows is transparency of policies. Here transparency would include national treatment and stability of policies over time. In fact, recent studies equate stability of policies with political stability. A clear statement of rules and regulations, legal redress in cases of conflict and non-discrimination, though a necessary condition, may not be sufficient for attracting and effectively utilizing FDI. There may be a gulf between what is on record and its implementation. That which is stated may not be implemented, and foreign as well as local firms may have to clear several hurdles to get the rules and regulations implemented. The stumbling block here is bureaucracy and corrupt practices. This is one reason for the observed discrepancy between approvals of FDI projects and actual numbers of projects. This is a problem that defies solution.

5. Crowding out

The overview note prepared by the UNCTAD secretariat discusses crowding out as a problem, one which has negative effects. It is worth discussing the phenomenon of crowding out

in some detail. This is a phenomenon first discussed in the context of macroeconomic policy. Public investments could crowd out private investments because of their effects on the rate of interest. But such crowding out, if it does occur, may leave the total amount of spending and output unchanged. In the context of FDI the worry, however, is that foreign investments may displace domestic investments. This would occur if FDI is a perfect substitute for domestic investment. Even so, total output would be unaffected. If FDI is complementary to domestic investment there would be an increase in total investment and output. And crowding out would occur in cases where FDI is relatively productive and outcompetes domestic investment. It should also be recognized that domestic investments which are crowded out may find investment outlets elsewhere in the economy. The problem, however, would arise in cases where FDI crowds out domestic investments with a potential comparative advantage. This is the classic infant industry argument. Even in these cases, inflows of FDI are likely to engender competition and spur domestic investments. It is an acknowledged fact that the efficacy of FDI and investment in general increases in the presence of competition.

6. Specific objectives and policies

Most of the yellow-light HCOMs prohibited under various agreements relate to specific objectives. As the overview note recognizes, these are prohibited under various bilateral and regional agreements but not by multilateral agreements. It is these policies that need discussion, and they are the ones that pose problems for the conclusion of a multilateral agreement on investment.

While discussing the costs and benefits of specific policies some of the characteristics of FDI should be noted. As often noted, FDI is a superb conduit for technology and know-how. It is, however, a catalyst of growth and not necessarily an initiator. Thus its efficacy is of a relatively high order in countries with a threshold level of human capital and growth. It

interacts with local resources and spurs growth. Quite often this catalytic nature of FDI is also referred to as a contagion effect, but for FDI to contaminate local resources, the latter have to be of a sufficient volume and should come into contact with foreign firms, principally through competition in the market place. The other point to note is that foreign forms are profit-maximizing entities – they are not social service organs. Admittedly, several TNCs do fund education and other public projects, but these are in the nature of charitable donations, and should not be associated with incentives such as tax concessions or exemptions from host country rules and regulations.

7. Local content requirements

It should be noted that specific host country policies towards FDI should not be ruled out on the basis of pre-set criteria. For instance, local content requirements should not be banned simply because they impact on international trade. One would be hard put to identify regulations, which in one way or the other, directly or indirectly, do not impact on trade. If this were the criterion, as in the case of WTO rules on local content requirements, several well-intentioned requirements would be banned. The primary criterion for judging host country rules and regulations should be twofold: first, whether or not they are designed to promote development objectives, and second, whether or not they interfere with efficient operations of foreign firms.

Information asymmetries and absence of knowledge of local market capabilities are a significant problem facing foreign firms in transition economies. Many of these countries do possess local entities capable of supplying components and parts to foreign firms. They fail to forge relationships with foreign firms mostly because of lack of information. Small and medium-sized firms in these countries may be hard put to obtain information on the requirements of foreign firms and more importantly make contact with foreign firms. These problems of information are much more severe for the foreign firms. Local

organizations such as Chambers of Commerce and producer groups may be expected to provide the sort of information on local capabilities that foreign firms require. So too should the commercial sections of embassies of host countries. But small-sized firms are not always members of local organizations and not all embassies are proactive in supplying the sort of information foreign firms need. In these cases, local content requirements may compel foreign forms to incur the search costs involved in locating local suppliers. Most foreign firms would source components from local suppliers if only they could be located, mostly because of savings in transport costs and goodwill of local governments that such sourcing would confer on the foreign firms.

For these reasons, banning local content requirements merely because they impact on trade may be short-sighted. Admittedly, imposition of local content requirements on foreign firms without at the same time facilitating the search process and providing incentives for local producers to upgrade the quality of their products may be counterproductive. The time-honoured infant industry case for protection is, in fact, based on externalities which specific types of investments generate. And the externalities that FDI is capable of generating, with the social rate of returns to investments exceeding the private rates of return, are acknowledged as one of the main benefits from FDI to host countries. Well-designed local content requirements, which provide foreign firms, with incentives to bear search costs and assist local producers in meeting the requirements of foreign firms may indeed generate externalities. These would include labour training, upgrading the quality of components and provision of market intelligence to local producers. The gist of this that not all local content requirements should be categorized as red-light HCOMS – several may belong to the yellow- or even the green-light variety.

8. Joint ventures

The one other yellow-light HCOM is the requirement to establish joint ventures (JVs) imposed by host countries on foreign firms. There is a vast literature on JVs from both economists and management specialists. At the expense of doing some injustice to this vast literature, received wisdom on JVs can be briefly summarized. JVs are a halfway house between wholly owned foreign subsidiaries and licensing agreements, which involve little or no foreign capital. Broadly in the context of developing countries, there are two types of JVs– mandatory JVs insisted upon by host countries and voluntary JVs.

Mandatory JVs reflect host countries' desire to delimit foreign control over operations, their belief that JVs enable them to garner a higher share of the rents generated by foreign firms than in the case of wholly owned subsidiaries and the belief that JVs facilitate transfer of technology and know-how to their nationals. Most such mandatory JVs fail mostly because of conflicts over decision-making and control over operations between local and foreign partners. They fail because of a lack of trust between the two partners, absence of complementarity between the resources committed by the two partners to the venture and generally a lack of understanding of the objectives. In cases where the local partner has nothing much to offer to the venture but is allowed to have a say in the decision-making process conflicts are bound to arise.

Voluntary JVs are of a different order – there is a commitment of resources by both partners to achieve pre-set goals. A major contribution of local partners to the venture is usually knowledge of local market conditions and the workings of the bureaucracy. It is also argued that JVs provide a sort of insurance for foreign firms against unwelcome policies of the host countries, including appropriation, because of the presence of local interests. Host countries may find an outlet for the investment of resources they possess in conjunction with the resources of the foreign firms.

Examples of voluntary JVs, however, are rare. It is mandatory JVs, which some commentators argue should be banned, that are frequently found, for the reasons stated earlier. Apart from the transient nature of mandatory JVs and the problems they pose, there is also the issue of the opportunity costs of the resources committed by the host countries to the venture. In savings-starved countries the opportunity costs of such ventures could be high from both a private and a social point of view. The investments forgone in the host economy could be much more socially profitable than investments in the JV. It is only in cases where both the social and the private rates of returns turn out to be higher than in alternative investments that JVs would benefit the host economy.

Even so, it can be argued that JVs do allow for participation of host countries, there are synergies from JVs, there may be scale economies especially in R&D if resources of two entities are pooled, transaction costs and risks could be spread across the two entities, they provide opportunities for learning by doing and learning by what foreign firms do, and they may be a political necessity.

But the issue, however, is whether mandatory JVs should be allowed. To say that they should be banned is not likely to sit well with the developing countries, whose overriding objective in stipulating compulsory JVs is the desire to share control over operations. It would also be reasonable to say that foreign-owned firms have the option of not investing in countries which mandate JVs. But if they bow to the strictures of the host countries, it must be because investment opportunities in these countries are attractive and they are prepared to bear the costs of entering into JVs, and because the gains from such ventures outweigh the costs. However, it can be argued that mandatory JVs should be banned in order to save the developing countries from "shooting themselves in the foot". Here the presumption is that the host countries do not know what is in their best interests and that they are willing to bear the opportunity costs of entering into JVs for the sake of non-economic objectives. This is an argument which is unlikely to sit well with the host countries.

Whether or not foreign firms comply with mandatory JVs depends on the mutual bargaining power of the host countries and the foreign firms. If the foreign firms comply with such requirements it must be that because their bargaining power is relatively weak, they are unwilling to forgo investment opportunities in the country. It must also be the presumption that host countries are willing to take the risk of losing the investments from foreign firms for the sake of whatever objectives they wish to promote through JVs. The one solution to the problem is to provide a set of guidelines or criteria to host countries which they have to comply with before insisting on mandatory JVs. These guidelines could include proof of complementarity of resources, synergies they expect from JVs and the nature of control over decision-making they expect to exercise. Mandatory JVs that should be excluded are those which are mandated for the sole purpose of exercising control over decision-making, with government nominees being the JV partners. In any case, one or the other of the two partners usually acquires most JVs over time and a blanket ban on mandatory JVs may serve little purpose.

None of the other yellow-light HCOMs, save the requirements to transfer technology and proprietary knowledge and R&D requirements, merit elaborate discussion. These other stipulations are unlikely to work in practice in the absence co-operant domestic resources. Some of these, such as requirements to locate headquarters in a specific region, restrictions on sales of goods in the territory where they are provided and employment performance requirements, may be designed for the promotion of regional incomes and employment, as well as to protect certain regions from the incursions of foreign firms. Here again it would be futile to attempt to deploy FDI for the promotion of regional policy objectives. Such equity considerations are usually at odds with efficiency of operations. Regional policy objectives should be pursued with instruments of domestic policy instruments, including regional subsidies for infrastructure development and education. These investments may, in fact, attract FDI to the regions, FDI flows to those regions in the country which offer

the sort of ingredients it seeks for efficient operations. Once located in a region with the sort of infrastructure and human resources that FDI requires, labour may flow from other regions to the one in which FDI is located. The pragmatic policy in these cases is for the institution of subsidies for labour training and education in general, and not controls over foreign firms.

9. Technology transfer and R&D

Two policies which are of interest are those relating to technology transfer and R&D. At first blush these requirements seem futile. Neither of them can occur in the absence of local capabilities to absorb and adapt technology and know-how. But specific requirements may have some merit in cases where FDI in a particular locale is attractive to foreign firms because of market potential and resource endowments of the country. It is likely that in the absence of specific stipulations to transfer technology, foreign firms may choose technologies and production processes which offer little by way of linkages to the host countries but which serve their objectives. In cases where the production functions are flexible and permit adoption of labour-intensive technologies that benefit labour training and technology transfer, foreign firms may opt to employ capital-intensive technologies. This they may do to preserve their monopoly over proprietary knowledge, especially in cases where intellectual property protection is absent. In these cases FDI may result in enclaves with few linkages to the rest of the economy. Stipulations enjoining foreign firms to transfer technology may induce them to adopt technologies that are appropriate to the factor endowments of the host countries and facilitate transfer of knowledge. This is, of course, subject to the caveat that such transfers of knowledge serve the interests of both entities. These stipulations may have to be linked to the provision of intellectual property rights.

10. Concluding remarks

In sum, performance requirements have a role to play in effectively utilizing FDI to promote development objectives. There are, however, several caveats to be borne in mind before endorsing such requirements. First, any requirement which is solely concerned with equity rather than efficiency of operations of foreign firms is unlikely to yield fruit. Second, in the absence of certain prerequisites such as infrastructure facilities, a threshold level of human capital and a stable macroeconomic environment, performance requirements are unlikely to be successful in promoting their stated objectives. Foreign firms cannot be expected to initiate development, only promote it. Third, performance requirements must be accompanied by policies that facilitate their implementation by foreign firms. Fourth, the principle of non-discrimination between locally owned and foreign-owned firms must be observed in the implementation of performance requirements.

The use and impact of performance requirements in the developed countries

A. Edward Safarian

In the 1960s to the 1980s, a number of developed countries regulated the operations of transnational corporations (TNCs), both at entry into a country and subsequent expansion, in response to concerns about the micro- and macroeconomic impact of such firms, their effect on income distribution, political independence and the distribution of power. This note reviews the extent of, and experience with, performance requirements for foreign direct investment (FDI) in the developed countries in that period. It focuses on performance requirements which are not restricted under multilateral agreements that is, requirements with respect to joint ventures and domestic equity, export performance, technology and research and development and employment and training. It does not deal with the considerable number of sectors where FDI was not permitted.[1]

There are relatively few studies on the actual operations of the government agencies involved in the developed countries, and even fewer on how effective the policies were in relation to their objectives. For these types of issues we have had to rely on a relatively small group of private and public studies.

The most comprehensive source for performance requirements is that for United States outward FDI in the benchmark surveys published every five years by the United States Department of Commerce. This source shows that in the 1970s and 1980s the incidence of performance requirements was much higher for developing than developed countries, and also relatively high in industries where TNCs were concentrated.

[1] For a more comprehensive review of the experience of performance requirements in developing countries, see Safarian (1993, 2002). This note draws mainly on those two sources.

In the developed countries the incidence of both equity requirements and other performance requirements was under 10 per cent even for those countries with the highest ratios. One reason for this relatively low figure is that a census of the entire historical stock of outward FDI will show a far lower incidence than would be the case for those firms which went abroad, or expanded by acquisitions, in the few decades when performance requirements were introduced.

The theoretical literature on performance requirements suggests that the welfare results depend on the model used and whether one is considering world welfare, that of the source country or that of the host. In general, where tariffs or other forms of protection cannot be removed and oligopoly exists, performance requirements can improve host welfare by reducing the market power of TNCs and playing a developmental role. A large literature since the 1960s on optimal intervention in the face of market failure also indicates that choosing the right policy for any given situation involves important information and implementation issues.

Three sets of countries can be distinguished with regard to policies in this area. One set is countries with some form of review mechanism for inward FDI and subsequent expansion by merger and acquisition. A distinction can be drawn here between five smaller natural-resource-rich host countries (Australia, Canada, New Zealand, Norway and Sweden) and two other countries (France and Japan). A second group consists of two largely host counties lacking formal review mechanisms but with substantial incentive programmes (Belgium and Ireland). The third set includes largely home countries lacking formal review (Germany, Netherlands, Switzerland, United Kingdom and United States). The absence of formal review, it should be added, does not mean the absence of ownership and other policies.

Foreign ownership was restricted to a minority position in a number of sectors in all of the countries reviewed. This was generally the case in services considered close to national

identity, such as media, aspects of finance where monetary control might be an issue, natural resources, some high technology sectors and defence sectors. Even without an explicit review process, in some countries there were large obstacles to takeovers (both domestic and foreign) because of close shareholdings, limited shareholder rights, and laws which encouraged all of this. All of the reviewed countries, with or without review mechanisms, also found ways to review and often stop takeovers of "key" firms by foreign interests.

However, such domestic ownership requirements were uncommon in manufacturing generally, where other performance requirements were the preferred form of regulation. It was also rare to require majority domestic ownership across a broad set of industries (outside natural resources) as witnessed in many developing countries. In both cases, Japan is a notable exception.

Australia and Canada had perhaps the most explicit policies on resource ownership, including a specific review agency. The Australian policy was to secure 50 per cent domestic ownership (though not necessarily effective voting control) in new natural resource projects. The rationale was to capture some of the rents on such projects in the absence of a capital gains tax and in the face of heavy subsidies by Australian States competing for the projects. The policy succeeded in the sense that foreign ownership in mining fell significantly for a time while overall FDI flows continued to rise. Without effective partners and with TNCs having some control of the timing of new issues, rents were often capitalized and Australians received only normal returns.

Rather than work at the margin, Canada undertook to directly reduce the high degree of foreign ownership and control of petroleum. The bargaining power of the Canadian Government, and the success of the programme, were sharply curtailed by three factors: opposition by the main producing province; collapse in oil prices in the early 1980s as an international recession took hold; and resistance by the United

States Government in particular to the discrimination against foreign-owned firms. Within a few years, as FDI fell, both the petroleum programme and the overall review mechanism for FDI were sharply modified to a more welcoming stance.

While all the countries studied had some form of ownership restraints, only Canada, France and Japan put major emphasis on other performance requirements in the review process. Canada had the most explicit review process among these. To correct for dependency effects, firms were required to give undertakings on a great variety of performance requirements, undertakings which could be increased in negotiations and which were formally monitored. There were several problems with the design of the agency. The crucial one was it was asked to implement a form of industrial policy, but without sufficient clarification of policy guidelines and in a decision-making process where every province and department of government could exert pressure up to the cabinet level. Many of the undertakings were far too general to be enforceable. Studies of the effects on capital flows are somewhat ambivalent.

One advantage of the less formal French review process was that the undertakings were relatively few, measurable and short-term, as with the amount of investment or employment generated. Hence they were more likely to be successfully monitored, especially where incentives accompanied them. The key issue is how well policy on FDI was integrated with industrial policy more generally, including the attempts to maintain a degree of French ownership in some high-value-added sectors which are also competitive internationally. While difficult to assess with the available information, the policy appears to have had limited success, in good part because it lacked continuity but also because of such factors as the constraints involved in membership in the EU.

Japan, by contrast, managed to keep domestic control of firms while importing large amounts of technology and developing highly competitive firms. Skilful application of industrial policy, specifically on FDI, certainly helped in this

process, but so did other factors, such as a large growing market, political and policy continuity, reasonable macro policies at the time, the existence of strong domestic firms as joint venture partners, and some aspects of business – government – labour relations which worked well for some decades in furthering these ends.

The issue for Ireland and Belgium, both small countries in a common market, is partly whether the incentive systems worked in attracting export-oriented TNCs. They apparently did work in the sense that a great deal of FDI was attracted to each country for a period, and the performance of the TNCs in terms of wages, exports, productivity and other factors was relatively strong. In each case, however, the older domestically owned firms did not benefit as much from the incentives, and internal linkages were weak. Both countries revised their policies to focus more, for example, on attracting international service projects, and developing demands for skilled labour and advanced technologies, including linkages to other domestic firms.

During the 1980s, policy on FDI became less restrictive in the sense that FDI was allowed into some sectors where it was formerly limited or prohibited, review mechanisms were ended or sharply limited, and incentives to FDI were increased. This was not simply liberalization, however. Rather, a form of selective national industrial policy developed at an international level. This was an aspect of a more strategic approach to trade and investment policy in a world where TNCs were also moving to a more globalized (or at least regionalized) structure of operations. The new approach involved at least three sets of policies. First, fiscal incentives for declining sectors have been supplemented by support for targeted newer sectors and advanced technologies. Second, some non-tariff barriers such as anti-dumping and countervailing measures have rapidly increased as forms of industrial support, even as many more countries have embraced open-economy approaches more generally. Finally, strategic trade and foreign investment promotion has been used in an attempt to capture more of the

rents and technological spillover involved in imperfect competition. The success of such strategic policies is complicated by, among other things, the constraints posed by integrated trade areas and by the spread of TNCs.

Some of the lessons to be learned from this review are briefly noted below.

- The theoretical and, especially empirical, material in this field is weak. Hence the conclusions drawn are qualified, especially on the effectiveness of the policies;
- FDI in the presence of market distortions can harm welfare. Hence the case for performance requirements, combined with incentives in some cases to ensure the targeted welfare outcomes;
- By the same token, there is a case for first-best policy provided that the market failure or distortion is domestic. This involves two policy instruments aimed at two targets – removing a tariff for example, and also the performance requirement which the tariff may require if FDI has entered in response to it. Where the market failure lies elsewhere, as in the TNC's policies, one solution is to aim for increased competition from other TNCs or from strengthened domestic firms;
- If first-best policies are not feasible, the key is to set up a process which is most likely to be effective. That depends partly on the policy capacity of a country. Japan's success with Japanese-controlled joint ventures was dependent on the presence of increasingly strong local partners as well as an unusual degree of skilful government – business collaboration. Countries without such policy capacity can try to develop it or rely on other modes of technology transfer;
- Any effective approach based on performance requirements requires reducing information costs in dealing with firms whose strategies vary, and reducing

policy implementation costs, while continuing to attract the desired FDI. These points are involved in each of the policy design issues which need to be resolved for example:

(a) Clarifying the key objective(s) so that trade-offs are possible with any secondary conflicting objectives (contrast Australia with Canada);

(b) Requiring relatively short-run, measurable, enforceable commitments, depending on policy capacity;

(c) Recognizing that there are constraints in integrated trade areas, hence a need to design these areas so that the constraints are known and acceptable in advance (NAFTA, EU);

(d) Ensuring the agency a degree of policy independence, as in the Industrial Development Authority in Ireland, a matter which is more complex in the more decentralized federal systems;

(e) Attempting to achieve as much policy continuity as possible, in the interest of policy planning and in that of TNCs (but changing it where it is failing, as in Canada, or with the country's changing international status, as in Japan);

- Policy design is ultimately decided by politicians and government officials, who will have to balance issues of economic welfare with a variety of other objectives. This is a matter which affects policy generally.

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PART II

Home country policy measures

Enhancing the development dimension of home country measures

John M. Kline

1. Introduction

Home Country Measures (HCMs) represent the often overlooked "third point" in the triangular relationship of foreign direct investment (FDI) that involves transnational corporations (TNCs), host countries and home countries. Included among HCMs are laws, regulations, policies and programmes in home countries that affect outflows of FDI. Although most policy discussions focus on the paired interaction of TNCs and host countries, HCMs also significantly influence FDI and can assume particular importance in shaping the magnitude and quality of FDI flows to developing countries. This brief assessment summarizes some of the ways in which multilateral rules might address HCMs in order to enhance their development dimension.[1]

The general absence of HCMs from international discussions stems from two primary factors. First, HCMs that historically restricted FDI outflows largely dissipated as most traditional capital-exporting countries progressively adhered to the OECD's Capital Movements Code. The relevance of HCM restrictions in newer capital-exporting countries, and the restrictive impact of non-traditional HCMs (such as investment-related trade measures), only recently began to attract attention. Second, HCMs to promote FDI outflows remain historically under the unilateral control of home countries that retain discretion over their design and application. Particularly in relations between developed and developing countries,

[1] Much of the material for this note is drawn from *Home Country Measures*, UNCTAD Series on Issues in International Investment Agreements (New York and Geneva: United Nations, 2001), United Nations publication, Sales No. E.01.II.D.19.

governmental obligations regarding FDI are essentially one-sided owing to the unidirectional nature of FDI flows, with rule obligations in practice falling only on the recipient developing countries. Six broad categories describe the scope of HCMs relevant to FDI flows.

2. Policy

While entirely absent from many international agreements, provisions containing policy declarations sometimes appear, especially in bilateral investment treaties (BITs) that state the home country's intention to encourage FDI flows. Essentially hortatory in nature, these provisions impose no obligations on home countries unless linked to follow-up provisions addressing other, more specific HCMs. Nevertheless, a policy declaration encouraging FDI flows, particularly to developing countries, provides a necessary, if by no means sufficient, basis for concrete steps that could increase the development dimension of FDI.

3. Information and contact facilitation

The collection and dissemination of information on the investment climate, and conditions and opportunities for FDI in developing countries constitute an essential first step in placing potential host counties on the radar screen of prospective foreign investors. HCMs can complement host country efforts in identifying and gathering the type of data on macroeconomic, sectoral, legal and social indicators reviewed by enterprises when compiling their initial "long list" of potential FDI sites. Enhanced cooperation and coordination between investment promotion agencies in developed and developing countries can improve both the quality and, especially, the dissemination of information to prospective investors, particularly to small and medium-sized enterprises (SMEs) that may lack both the experience and resources necessary to collect information broadly themselves. This cooperation could prove especially

beneficial for many least developed countries without a long history of hosting FDI that might not otherwise be targeted by firms in an information-gathering effort. Technical assistance might also be provided to improve regulatory, administrative, management and financial capacities in developing countries relevant to their general FDI climate.

Taking the information phase one step further, HCMs can also facilitate dialogue and contacts between prospective foreign investors and FDI promotion services in developing countries. Working with chambers of commerce and business associations, cooperative programmes can arrange seminars in the home country, investment missions to the host country, and even offer "matchmaker" services to introduce prospective foreign investors to potential local business partners. Again, these facilitation HCMs could prove most beneficial to SMEs in both home and host countries, and to smaller, least developed countries that, on their own, might not otherwise attract the critical mass of investment prospects needed to initiate such activities.

The key points relevant to enhancing the development dimension of these HCMs are: (a) substantial developing country input and involvement, as a cooperative partner, in the design and execution of programmatic HCMs to increase the accuracy and efficiency of data collection, the effectiveness of contact facilitation, and the responsiveness of FDI attracted to the host country's development priorities; (b) attention to overcoming market imperfections, where the absence of easily available information on FDI opportunities in many developing countries can seriously impair their chances for evaluation by a prospective investor; and (c) an expanded network of informed business enterprises in home countries that are interested in and supportive of HCMs to encourage mutually beneficial FDI flows to developing countries.

4. Technology transfer

Technology transfer constitutes a priority goal for many host developing countries, but few address this factor specifically. Some technology transfer is involved with technical assistance to improve the developing countries' general investment climate, as discussed earlier. Another form of technology transfer can occur to help developing countries comply with obligations undertaken as part of multilateral rules, such as with the Agreement on Trade-Related Aspects of Intellectual Property (the TRIPS Agreement) or the Framework Convention on Climate Change and the Kyoto Protocol. In these cases, the self-interest of developed countries in building the technological capacity of developing countries to carry out treaty provisions could be further ensured through provisions that clearly make a country's obligatory compliance contingent on sufficient technology transfer to provide effective capabilities.

Technology transfers related to more specific FDI project applications are generally introduced in HCMs as a priority assistance objective rather than as a separate policy or programme. For example, financial or fiscal HCMs can favour FDI projects that will transfer the most effective technology to the host country. In these cases, the development dimension could be enhanced by host country participation in the evaluation of potential technologies most appropriate to development needs and objectives, and through the promotion of FDI modalities that increase the integral involvement of local business partners in an FDI project.

5. Financial and fiscal incentives

The HCMs that hold the greatest obvious attraction for both investors and host countries are financial assistance and tax incentives that favour FDI flows to developing countries. These HCMs are usually embedded in foreign assistance programmes that may, or may not, focus specifically on FDI-related

development objectives. Assistance programmes may also be administered through multiple home country agencies that lack adequate coordination among their activities. Financial incentives can be structured to promote particular policy objectives, such as providing support for pre-investment studies (especially important for SMEs) or for projects that would transfer technology or improve environmental protection programmes. Financial support can come in many forms, including grants, loans, loan guarantees and equity participation in the project.

HCMs whose financial incentives for FDI outflows appear as direct line-item expenditures on agency budgets are likely to prove especially controversial in the politics of the home country. Domestic groups opposed to FDI outflows in general would object doubly to encouraging such outflows with taxpayer monies. One method of ameliorating some domestic opposition is to "tie" bilateral financial assistance to FDI projects that specifically benefit home country TNCs (thereby creating some offsetting domestic political support for the HCMs) and preferably benefit the home economy as well (such as through supplier or "pull through" exports to the new FDI project). The "tied" aspect of such bilateral assistance can limit host country options and decrease the potential efficiency and developmental benefits of the project. Alternatively, providing such financial incentives through regional or multilateral institutions can enhance the developmental dimension of FDI incentives, but this approach will lessen the domestic political support in most home countries for increased budgetary allocations to support FDI projects that may benefit competing trading partner countries and companies.

Fiscal HCMs influence FDI flows to developing countries mainly through tax policies and transfer pricing regulations. Countries employing a residence-based system of taxing foreign-source income can claim tax revenues on income generated by FDI projects in developing countries. Even though credits may be given for local taxes paid, such extraterritorial tax policies may actually offset the effect of lower tax rates

offered by developing countries as an incentive to attract FDI. A way to avoid this detrimental developmental effect would be to adopt "tax sparing" policies for TNCs operating in developing countries. Similarly, transfer pricing regulations employed by developed countries can affect both the profitability and the revenue distribution of FDI projects in developing countries. An OECD Model Tax Convention establishes the principle that host countries should adjust their tax claims downward in the event of double taxation effects. The development dimension of FDI could be enhanced if tax treaties applied an exception to this principle for developing host countries.

6. Investment insurance

Government programmes offering insurance against political and other non-commercial risk not covered by private insurers constitute a direct and widely known type of HCM that facilitates FDI flows, especially to developing country areas where perceived risks to FDI may by relatively high. In these terms, such efforts can be viewed as overcoming imperfections in the private market place. Relevant programmes are offered by home countries, regional organizations and, since 1998, by the Multilateral Investment Guarantee Agency (MIGA). Maintaining some breadth and complementarity among available programmes may provide a beneficial flexibility for the range of FDI projects undertaken in the diverse array of developing countries.

7. Market access regulations

The relatively simple and easily understood operation of investment insurance programmes contrasts with the set of HCMs that influence FDI by restricting or granting preferential access to home country markets for exports from FDI projects. These HCMs fall under the recently coined term "investment-related trade measures" (IRTMs). Traditional trade measures such as anti-dumping regulations and product certification

standards can act to restrict access to developed country markets from host developing countries. These restrictions reduce the profitability of actual or potential FDI projects that seek to use comparative cost advantages in the developing countries to produce for developed country markets. Such HCMs can prove especially costly for developmental goals by discouraging the type of productive, export-oriented FDI sought by many developing countries. Formulating and then actually implementing provisions that call upon developed countries to give special consideration to developing country interests in administering restrictive market access provisions would help protect the development dimension of FDI from the impact of such IRTMs. Such a principle is outlined in the 1994 Agreement on Implementation of Article VI of the GATT, relative to anti-dumping measures.

Other types of market-access HCMs operate in a reverse manner by opening developed country markets to (certain) developing country exports. Another presentation will discuss examples of such programmes that are sponsored by the European Union. These IRTMs influence FDI by encouraging the assessment of projects in developing countries whose production might be largely destined for home or other developed country markets. The potentially perverse feature of these preferential market-access programmes is that only certain developing countries qualify for favoured treatment, which gives them a relative advantage as an FDI location over other developing countries that remain outside the eligible grouping. The selection of favoured developing countries may be based on historical, regional or political ties to the developed country or countries operating such schemes, or it might be linked to relative levels of economic development. While such HCMs promote developmental aspects of FDI, the beneficial impact falls upon some (as largely selected by the developed countries), while other developing countries are relatively disadvantaged in their efforts to attract comparable FDI.

Rules of origin represent a related measure whose application as an HCM could benefit or distort the developmental impact of trade-related FDI in developing countries that are eligible for preferential market access arrangements. By specifying the stage or level of value-added production that must occur in the eligible host country, the rules of origin definitions adopted by the developed country can shape the nature of the FDI attracted to a host developing country by a preferential market access programme. Discussions on possible efforts to harmonize rules-of-origin definitions could eventually ameliorate the differential effects of these HCMs, which currently remain under the unilateral control of the developed regional or country market that administers the preferential programmes.

8. Enhancing the development dimension: Notions for discussion

In considering ways to enhance the development dimension of FDI, a number of possible notions arise from the above explanation of HCMs. The following ideas are offered as notions for discussion, intended to stimulate greater attention and a cooperative exploration of the topics. In general, most steps would require a demonstration of political will on the part of developed home countries to favour development objectives. The political practicality or probability of such actions will vary among the topics discussed, with actions aimed at removing market imperfections perhaps easier to achieve than programmes offering significant preferential treatment for developing countries. Many realistic options will also seek a synergy between developed and developing country objectives, incorporating opportunities for mutual benefit gains.

Certainly a minimal first step is to seek *at least* hortatory policy declarations in international instruments that recognize the normative responsibility of developed home countries to promote beneficial FDI outflows to developing countries. These policy statements should be linked, wherever possible, to

practical follow-on implementation programmes. Among the most persuasive rationales for such programmes will be the need to overcome market imperfections that currently inhibit FDI flows, including the collection and dissemination of investment climate information and the provision of basic technical and management training that could remove bottlenecks to FDI flows to many developing countries. Facilitating contacts between businesspeople in home and prospective host countries would similarly improve market knowledge. In addition, increased direct contacts among societal groups could expand the base for a domestic home country constituency that understands and supports FDI-related programmes for developing countries.

Financial and fiscal incentives present a dilemma for developing country Governments. Channelling such assistance through regional or multilateral programmes can enhance the relative negotiating leverage and increase the options available for developing countries. However, the trade-off may be reduced financial flows as domestic support for such expenditures dissipates when the shift from bilateral to multilateral assistance programmes remove the aid "ties" that benefit the donor home countries. Although developed countries have recognized in forums such as the OECD that "tied" aid creates undesirable inefficiencies that can reduce the developmental impact of assistance, the political reality of national government budget processes is that the domestic constituency for foreign assistance programmes is woefully weak in most developed countries.

Should international discussions result in possible restrictions of the use of FDI incentives, specific exceptions should be applied to home country programmes that promote FDI outflow to developing countries. The provision of outflow incentives by home countries is obviously more beneficial for developing host countries than their own use of financial incentives to attract FDI. Of course, the major difference lies in the structuring of the incentive that influences the shape of the FDI project. The country financing of the incentive normally

determines unilaterally how the incentive will work to favour particular sectors or types of FDI projects. Increased cooperation among the investment promotion agencies in developed and developing countries could help dilute this unilateralism by providing increased input from developing countries in designing incentives consistent with the development priorities of the host country. Cooperation should also extend to the objective of ensuring that TNC performance matches the projected developmental impacts of FDI that receives the benefits of FDI incentives.

Relating HCMs to the long-standing most favoured nation (MFN) principle will also present some complex issues for developing countries, covering at least two applications that distinguish among various groups of developing countries. One distinction relates to restrictions on FDI outflows. Although most traditional capital-exporting countries have largely removed such restrictions through adherence to the OECD Capital Movements Code, a number of newer capital-exporting countries are not subject to the Code and can employ restrictions on FDI outflows. An issue arises as to whether all countries should remove FDI outflow restrictions on an MFN basis, or whether exceptions should be allowed for countries at certain stages of development, and, if so, how those stages might be defined. For the least developed countries with minimal outward FDI, this issue is not relevant, but for a number of developing home countries with their own growing numbers of TNCs, the issue may have some importance.

A more broadly applicable dilemma arises when programmes grant preferential market access, financial or fiscal incentives, or other FDI promotional advantages only to certain developing countries on the basis of historical, regional or other factors, such as favouring the least developed countries. In differentiating among developing countries on some set of characteristics, FDI promotion or facilitation programmes will almost inevitably prioritize the development objectives of some countries to the apparent relative disadvantage of other developing countries. Similar prioritization issues arise when

programmes favour FDI projects that promote certain goals, such as environmental improvements, but in these cases the distinctions are made between policy objectives rather than recipient countries. Further informed and candid discussions among developing countries may be warranted in order to address this issue in the most constructive, mutually beneficial fashion.

Extraterritoriality is also relevant to HCMs, in terms of direct legal applications and of indirect country impacts. In a few cases, such as taxation and antitrust regulations, HCMs may be applied extraterritorially to home country TNCs. In most instances, the potential infringement on nation-State sovereignty threatened by the extraterritorial application of a nation's laws argues against this mode of TNC regulation. Occasionally, developing country interests might be advanced with the aid of extraterritorial home country regulation of TNCs, such as historically in the case of operations in an apartheid South Africa or more currently in the efforts to prevent illegal capital flight from developing countries. Where extraterritorial laws are invoked, maximum cooperation is essential between home and host country Governments to avoid conflicts and assist with the developmental requirements of developing countries, for example, in the administration of transfer pricing policies.

A provision in the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices (RBPs) suggests one way of recognizing and enhancing the development dimension of FDI when the administration of HCMs is at issue. Whether the extraterritorial dimension of an HCM arises from direct legal enforcement or from indirect economic effects, the home country can take into account the development, financial and trade needs of developing countries, as called for in the RBPs Code. Such consideration might take several forms and could apply to various types of policy areas beyond the control of RBPs.

For example, the recent wave of international corporate mergers and acquisitions (M&As) attracted the scrutiny of competition authorities in many home countries, but numerous impacts from these global consolidations are played out in the altered operations of TNC affiliates in developing countries as well. Home countries might agree to notify developing countries that are host to related enterprises when M&As come under scrutiny, sharing with the developing countries pertinent data and incorporating their concerns and interests into the case's overall assessment.

Such cooperation could be sought more broadly so that developing countries are notified at an early stage when TNC restructurings could adversely affect development plans and projects. Such early notification requirements exist in some developed countries when TNC plans outside the country will significantly affect the developed countries' employment interests. Similar consideration could be shown to the development interests of developing countries through notification and consultation arrangements, agreed through multilateral rules, applied through home country regulations and/or adopted voluntarily as a part of TNC corporate social responsibility (CSR). The use of CSR standards and modalities constitutes another relevant avenue for increasing the development dimension of FDI. These mechanisms can certainly be encouraged and promoted by HCMs, incorporating also a role of non-governmental organizations. However, this topic is not elaborated in further detail in this note.

An even broader notion would be to seek some type of "developmental impact statement" for existing or new HCMs that are likely to substantially impact on FDI prospects in developing host countries. Although adopting such a process would require an unusual measure of political will, home countries could undertake this step in formal recognition of the special conditions applying to relations with developing countries. Whether direct or indirect, extraterritorial in application or just in impact, HCMs can significantly affect how actual or potential FDI relates to developmental prospects. A

"developmental impact statement" accompanying new or significantly changed HCMs could inject this developmental consideration into the home country's policy decision, perhaps with some relevant developing country input to the statement's preparation. Such a process would increase the international transparency of HCM procedures and promote greater attention to the developmental consequences of HCMs that traditionally have been adopted unilaterally, with a nearly exclusive focus on home country interests. Where HCMs may harm development objectives, perhaps quite unintentionally and unexpectedly, advance consideration of such likely impacts could foster ways to avoid, ameliorate or offset the harmful effects.

This overview suggests a broad range of HCMs that help shape the developmental impact of FDI in developing countries, even though such measures traditionally have not played a substantial, or often even marginal, role in international discussions. Greater attention to the role of HCMs would seem essential for incorporating the "third point" of the triangular relationship between TNCs, host countries and home countries. Exploring ways to introduce greater consideration of developing country interests in the design and implementation of relevant HCMs also appears a beneficial way to enhance further the developmental dimension of FDI.

Home country measures: Some food for thought

Percy S. Mistry

1. Introduction

Source (home) countries in the Organisation for Economic Co-operation and Development have long supported FDI[1] flows to developing countries through a large number of broad and specific measures. Broad measures have included those aimed at improving macroeconomic regimes (monetary, fiscal, trade and exchange rate); sector and industry environments and policies; the climate for business and the microeconomic environment for firms; foreign investment regimes; physical infrastructure with preferential access for incoming investors; capacity building for related institutional infrastructure; and health, education, training and other measures for human resources. Specific measures have involved direct FDI support through bilateral and multilateral investment agencies; multilateral and bilateral risk insurance cover for non-commercial risk; investment promotion and reduction in information asymmetries; reducing administrative barriers to investment and foreign investment; bilateral investment and double-taxation treaties for confidence building; support for industry-to-industry and business-to-business links for hard/soft technology/know-how transfers between home investors and host affiliates; preferential access to home markets; specific export market access linkages; support for supply chain linkages within intra-firm and intra-industry structures; and export processing zones, special economic zones and industry clusters.

[1] To avoid tedious repetition, all references to FDI throughout this note mean "FDI flows to (or in) developing countries" unless the context clearly indicates otherwise.

That is an indicative rather than a comprehensive, exclusive list. Many of the interventions listed in the two categories above involve home and host countries cooperating and interacting with each other rather than acting alone or independently. This note makes no attempt to cover all the items in the above list. Instead it confines itself to making a limited contribution by focusing on recommendations relevant in discussing the broader question of home country policy measures (HCMs).[2]

The reasons for focusing on least developed countries (LDCs) are not difficult to understand, although they account for an insignificant fraction of FDI. In a world in which trade and investment regimes are being liberalized very rapidly, the 49 LDCs[3] are ill placed to compete for FDI with the other 150 countries that are developing or in transition. Least developed countries face intense competition in attracting FDI from more competitive low-income countries that are not least developed countries (e.g. India, Pakistan and Viet Nam), as well from countries like China and even some transition economies, whose productivity-adjusted wage levels are more attractive that those than most least developed countries can offer. These competitors are more industrially advanced, better endowed with human, social and institutional capital and have large domestic private sectors. Many do not need home country interventions on any significant scale to attract more FDI and need to rely more on host country measures. But least developed countries do need perhaps a disproportionate amount of help from home countries in pushing FDI in their direction.

Given the enormous structural, physical, human and institutional disadvantages they have, LDCs will not grow or develop unless they are able to attract FDI, provide a congenial

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[2] For a fuller treatment of the issues, see *Mitigating Risks for Foreign Investments in the Least Developed Countries*, Development Financing Study 2003:1, prepared by Percy S. Mistry and Niels E. Olesen for the Swedish Ministry for Foreign Affairs, Stockholm, 2003.

[3] Fifty if East Timor is also included as it inevitably will be.

home for it, and benefit from its presence by absorbing its strengths into the local economy. Before they can do that, they need to lower the barriers they pose to FDI that heighten commercial and non-commercial risks that foreign investors have to take. If a virtuous spiral of inward FDI to least developed countries is to be sustained it will need official home country help in the short and medium term. But such help will need to be phased out over the long term in order to avoid a permanent subsidy element becoming embedded in supporting FDI flows to least developed countries. There are a number of things that home countries can do in the short, medium and long term to mitigate risks and unblock FDI flows by addressing both the entry-cost and post-entry risk barriers that investors confront.

2. Extending extant risk mitigation capabilities

(a) Increase funding of multilateral risk insurance agencies (e.g. Multilateral Investment Guarantee Agency (MIGA)) and the political risk insurance (PRI) facilities being opened up in regional banks specifically to cover LDC political and other non-commercial risk through a special purpose capital or guarantee pool provided perhaps by the "like-minded group of donors" dedicated to covering political risk in least developed countries.

(b) Create more effective regional risk cover capacity either by: (a) regionalizing more effectively the operations of, and capital pools available to, MIGA and transforming it into a more independent (i.e. of the World Bank) global facility that can be enlarged and shared through "equal access partnerships" by all the multilateral development banks (MDBs), and not confine MIGA to being affiliated simply with the World Bank; or (b) if that cannot be done easily and effectively, create a separate MIGA-like regional multilateral political risk insurance capacity affiliated with the regional development banks. In either case such capacity should have dedicated pools of capital

and human resources that would focus more intensively than either MIGA or the regional banks currently do on LDCs in each region.

(c) Increase the non-commercial risk insurance (NCRI) capacity of bilateral export credit agencies (ECAs) and official bilateral insurers (OBIs)[4] through specific funding or subsidies for covering a much wider range of non-commercial risks in least developed countries.

(d) Encourage and, if necessary, subsidize start-up of cooperative underwriting programmes (CUPs) based on the MIGA model at the bilateral (home country) level between official bilateral insurers and private insurers in the domestic market. Efforts need to be made to encourage home country official bilateral insurers and private insurers with a presence in the political risk insurance and non-commercial risk insurance market to explore what might be done to:

   (i) Provide risk cover for least developed countries, many of which are currently off cover;

   (ii) Develop standardized non-commercial risk insurance cover policies for LDCs; and

   (iii) Extend further the attempts being made to provide "enhanced breach of contract cover" to include "contract frustration" and "politically induced business interruption" risks.

The process of developing public – private partnerships (PPPs) between official bilateral insurers and private insurers for providing joint risk cover in least developed countries by building on their respective strengths (i.e. capital on the part of the private insurers and salvage/recovery advantage on the part

[4] Many export credit agencies are also official bilateral insurers but in some countries (e.g. the United States) export credits and non-commercial risk insurance are provided by separate institutions (e.g. the United States Exim Bank and OPIC respectively).

of OBIs), and for developing insurance products that meet the real risk insurance needs of potential foreign investors in least developed countries, needs to be kick-started. Home country Governments and official bilateral insurers could play a useful role in taking a step in this direction.

(e) Encourage and strengthen PPPs at the European level by pooling the capacity of European official bilateral insurers and EU private political risk insurers to cover political risk insurance and non-commercial risk insurance in ACP LDCs.[5] Capital set-asides by official bilateral insurers could be matched by a capital grant from the European Development Fund (EDF) for this specific purpose.

(f) Provide project-related subsidies to cover part of the premium costs for professional risk insurers or NCRI for specific projects being undertaken by OECD source country or eligible developing country firms in least developed countries.

(g) Encourage the development of PPPs between official bilateral insurers and their nascent counterparts in key developing countries that are becoming major source countries for FDI in neighbouring least developed countries (i.e. with ECAs in India for LDCs in South Asia; in Thailand and Malaysia for FDI in Cambodia and the Lao People's Democratic Republic; and in South Africa for LDCs in Africa).

(h) Establish credit enhancement arrangements (through guarantees such as that provided by the Swedish International Development Agency (SIDA) recently for a South African cellular operator investing in Uganda) for

[5] The problem here might be that private insurers may not wish to have their political risk insurance exposure publicly known. The problem could be overcome in two ways: (a) either through the MIGA approach of announcing the overall limits before hand and then showing the specific instances of cover as MIGA risk exposure; or (b) respecting private insurer concerns about privacy by not making public their share of risk exposure.

mobilizing available domestic funding (in order to reduce currency risk) in developing countries (particularly LDCs). Bilateral aid agencies could complement the capacity of OBIs by using their resources to encourage local currency funding of infrastructure projects and reduce investor currency and funding risks by expanding their guarantee operations for credit enhancement. This can be done by adding directly to bilateral donor agency risk capital resources for this specific purpose, but also by using the "callable capital" device employed in the MDBs for this purpose without necessarily drawing down immediately on cash budgetary resources, and by providing the cash budgetary allocation only when the insurance cover actually has to be paid out.

3. Other ways of increasing FDI flows to LDCs

(a) Provide full (100 per cent) or large partial (50–80 per cent) tax credits, rebates or deductions (depending on which of these would have the greatest impact on influencing investor behaviour in the home country concerned) for the equity invested by home country companies in LDCs against their tax liabilities in their home countries.

(b) Establish special-purpose "FDI-in-LDCs" investment promotion departments (with commensurate budgets) within bilateral aid or investment agencies, thus ensuring that support for FDI flows is as important a bilateral priority as any other in aid programmes. These departments would work closely with specific investment promotion agencies (IPAs) – from at least eight to ten LDCs that feature prominently in a bilateral donor's aid programme – to "market" the investment potential of each of those least developed countries in donor countries on a specific targeted basis. They would extend the limited capacity of LDC IPAs enabling them to leverage their limited resources.

Their activities would include:

(i) Determining investment priorities with each of the LDC IPAs they are working with;

(ii) Targeting specific companies and TNCs in their home countries;

(iii) Apprising them of opportunities in LDCs and doing the necessary groundwork for providing them with basic information about the specific investment possibility;

(iv) Screening firm prospects and arranging for LDC IPA officials to visit targeted companies for intensive interviews and discussions in the pre-investment stage;

(v) Helping to finance environmental and social impact assessments and meeting other pre-investment costs that may otherwise deter the investor company from going further;

(vi) Helping to prepare documentation to facilitate investment decision-making;

(vii) Undertaking targeted media initiatives in their countries to present these LDCs and the investment opportunities they offer in a positive light; and

(viii) Institutional capacity-building in partner IPAs through intensive arrangements for staff training, exchange programmes and arranging greater LDC IPA staff exposure to the corporate world in home countries that are major sources of FDI.

(c) Augment bilateral aid agency capacity in host country offices to liaise locally with the LDC IPA concerned in following up on specific investment project opportunities by including experienced (retired volunteer?) private sector specialists in field development cooperation offices (DCOs) on a pilot programme basis for two years in three or four LDCs (e.g. Afghanistan, Bangladesh, Angola, United Republic

of Tanzania). If the pilot was successful, the programme could be expanded to all LDCs in which the donor country had a major interest.

(d) Increase direct bilateral participation in private infrastructure funds (such as SIDA's participation in the AIG Africa Infrastructure Fund (managed by the Emerging Markets Partnership) through more consistent PPP arrangements and orient these funds towards LDC investments to the extent possible rather than having them concentrate mainly on non-LDC countries.

(e) Explore the possibility of establishing a small special-purpose LDC infrastructure investment fund that would provide equity and debt financing as well as mobilize domestic currency resources for lending to infrastructure projects in LDCs outside Africa as well (especially in West, South and East Asia and in the island LDCs of the Pacific).

(f) Set up a risk mitigation advisory service for foreign investors in LDCs and especially for investors from other developing countries, who would not have either the resources or the network capability to deal with major private insurers, OECD, OBIs or MIGA. This service would "package" risk cover services for investors in a similar fashion to a specialized insurance broker.

4. Medium term initiatives by home countries

Over the medium term the efforts of home country (through their aid agencies) to generate sustainable FDI flows to LDCs might focus on activities that would take longer to show results than the options listed in the previous two sections. Although these activities might bear fruit only after five years or so, they need to be started now, at the same time as the short-term measures indicated above. These activities should include:

- Working with multilateral partners and the private sector to develop financial systems and capital markets of least developed countries more rapidly than currently envisaged. If financial markets in LDCs are not improved quickly (with the import of talented human capital as is characteristic of any sophisticated financial market anywhere today) they risk being permanently disenfranchised in a globalising world;
- Where bilateral aid agencies can make a unique contribution in comparison with multilateral counterparts (whose comparative advantage lies in policies and other more macro and meso functions) is in engaging in intensive “regulatory-partnership” arrangements between financial system regulators in particular donor countries and regulatory agencies in LDCs to ensure not only that sound laws, rules and regulations are developed, but also that they are applied and enforced;
- Bilateral aid agencies can provide seed funding to encourage their non-banking institutions to establish a presence in least developed countries' financial systems that would be shunned by the private sector. They need to subsidize the costs of entry into LDC markets of their securities exchanges, insurance companies, pension fund and asset management companies, their household finance and mortgage companies, and their postal and giro savings systems for small savers in least developed countries. They also need to facilitate the development of securities and insurance brokerages and smaller financial service firms in LDCs to “force” a pace of development of the financial system that would otherwise simply not occur;
- Bilateral donors (especially members of the EU) can do more to:

(i) (a) Provide open access to their domestic consumer markets to all products of LDCs; (b) encourage their domestic firms through favourable tax treatment or through grant support for partial cost coverage (e.g. trading firms, supermarkets and other consumer goods retailers) to develop supply sources so that LDCs can take advantage of the preferential access they have but of which are not availing themselves; and (c) encourage developing country investors to invest in LDCs to take advantage of privileged access to donor markets. Privileged and preferential market access for LDCs should be provided between now and 2010 when it should start being gradually phased out, and completely phased out by 2015;

(ii) Set up an International Commercial Court (ICOM) specifically designed to resolve disputes between LDCs (not all developing countries) and foreign investors, especially where complex infrastructure investments involving regulatory risk are concerned. ICOM would aim to address the core difficulty that requires foreign investors to acquire political risk insurance, the premiums for which are particularly expensive where LDCs are concerned. It should be set up to resolve all disputes within a maximum period of 12 months, with the costs of civil action being shared equally by the foreign investor and the least developed country's Government (or government agency concerned). Home country aid agencies could agree to subsidizing 50 per cent of the operating costs of such an institution for the first 10 years. The existence of such an institution would help to lower political risk insurance

premiums considerably. All FDI in all least developed countries would be automatically subject to ICOM's dispute resolution and adjudication jurisdiction.

5. Long-term options for home countries to consider

Other long-term options (0–10 years) that home countries might consider include addressing those barriers to FDI that are currently not being addressed adequately:

(a) Providing sustained long-term institutional and human capacity-building assistance for LDC accounting, legal and judicial systems to improve their performance and capacities when it comes to dealing with foreign investors swiftly, impartially and equitably. Such assistance could be provided through counterpart accounting, legal firms and judiciaries in partner donor countries through long-term partnership programmes that would be partly funded by aid. For foreign investors to have credibility in such systems over the medium term, it may be necessary to staff local commercial courts in LDCs with expatriate adjudicators, judges and advocates from donor countries and have them phased out over 10–15 years, by which time total confidence in LDC nationals being able to run these systems with the same degree of professionalism and probity should have been established in the minds of foreign investors.

(b) Providing similar support for political and broader governance institutions, namely government machinery and ministries, especially the law and justice ministries, as well as for parliament and parliamentary institutions, for the effective functioning of democracy, and representative civil society institutions that can exert additional checks and balances in ways that even parliamentary systems in developed countries cannot.

Such efforts should be based on the premise that economic reform cannot be sustained without addressing and following through on urgently needed reforms of the way in which governance in LDCs functions at all levels. It is not enough for donors to proselytize and wring their hands endlessly about this issue. It needs to be tackled decisively. Political and governance reform should be tackled on the same footing and in the same way as economic reform. Indeed, in some LDCs it may be appropriate to take a pause in pushing through successive rounds of further economic reforms that are unlikely to work unless they can be embedded in political and judicial reform. The latter may need more emphasis than the former in LDCs (and other developing countries) over the next decade.

Such assistance would include long-term partnership arrangements for institutional and capacity building between counterpart ministries in donor countries and LDCs (with each donor picking no more than two LDCs or vice versa), as well as between their parliaments; ombudsmen and watchdogs such as central auditing and accounting agencies; judiciaries; labour unions; chambers of commerce and industry associations; and between their NGOs (although these would need to be carefully selected to ensure that these partnerships are productive rather than counterproductive).

(c) Extending Euro-supported CFA arrangements in francophone West Africa to monetary unions in other parts of Africa (e.g. the rand zone in the Southern African Development Community (SADC)) and encouraging the creation of monetary unions that can create and sustain "credible currencies' in East and Central Africa. In the absence of a restoration of faith in African currencies that can become acceptable stores of value and medium of exchange, it is difficult to see how domestic savings in African LDCs can be raised from

their current dismal levels to levels that can support sustainable financeable resource gaps between domestic savings and investments while raising overall investment to levels required to achieve growth rates of 7 per cent.

Beyond the direct long-term interactions between bilateral donors and LDCs to improve the institutional foundations on which FDI (and economic activity) can rely there are longer-term measures that home countries need to consider for the future development of PRI and NCRI markets themselves on a broader basis. These measures (taken not by aid agencies but by finance ministries, regulatory agencies and monetary as well as securities exchange authorities, but most especially by their OBIs, private insurance companies and capital market players) include:

(d) Supporting the future evolution and development of PRI and NCRI capacity in their own domestic markets and in the wider regional European market through more productive PPPs between official bilateral insurers and private risk insurers.

(e) Facilitating the entry of political risk insurance and non-commercial risk insurance derivative products into capital and derivative markets by sponsoring research and development of PRI and NCRI derivatives based on experience gained and lessons learned in credit derivative markets as well as in catastrophic risk markets.

A future generation of new derivative products in these markets – aimed at transforming open-ended (and unmanageable) indemnity risk to which insurers are exposed over the long term into limited capital market risk that might be shared by a much broader range of risk-takers interested in making such markets – is clearly needed. This development would enable PRI and NCRI risk to be shared over a much larger global capital pool than exists in insurance markets – whose own capital pool can contract quite dramatically when events such as

those of 11 September 2001 occur – and would permit such risk to be traded in a more transparent manner, adding also to liquidity.

This broad wish list of possible measures over three temporal horizons provides perhaps much too rich a menu for immediate digestion without further discussion and considerably more thought and research. No claim is made as to the net benefits that such measures might yield after their costs have been taken into account. It is more the initial ideas that are within the borders of practicability and "do-ability" that are in need of further thought followed by dismissal or development.

FDI in the ACP – EU development cooperation: From Lomé to Cotonou

Sanoussi Bilal
and Dirk Willem te Velde

1. The Lomé experience

Initially, investment was directly addressed under the framework for development cooperation between the African, Caribbean and Pacific (ACP) countries and the European Union (EU). The first Lomé Convention did not provide for any specific measures in the field of FDI. It dealt instead with industrial cooperation in general, and with the creation of the Centre for Industrial Development (CDI), which later became the Centre for the Development of Enterprise (CDE). The emphasis on industrial cooperation and development remained during Lomé I and II. It is only with Lomé III that investment promotion provisions were formally introduced. Lomé IV and IVbis continued to devote further attention to investment issues by explicitly covering investment promotion and protection as well as financing of and support to investment.

Nonetheless, the process remained heavily administratively driven, with little direct pro-active involvement of the private sector. The interest of the EU business in ACP countries remained limited, if not marginal. The lack of a business-friendly environment in many ACP countries, coupled with the fragmented nature of the support provided by the EU, led to extremely disappointing results in terms of effective domestic and foreign investment in most of the ACP countries.

2. The Cotonou Agreement and investment

The underlying principles regarding the approach to investment promotion and facilitation in the ACP countries rest on

some basic considerations: an open economy, a stable and democratic environment, respect for the rule of law and some core principles of good governance, the active involvement of the private sector, the strengthening of regional integration together with the integration of the ACP into the world economy, sound macroeconomic policies and a business-friendly environment. The Cotonou Agreement, with its various components, entails in some form or another all these elements.

The justification for the approach adopted under the Cotonou Agreement is that trade liberalization, and more generally openness of the ACP economies, will stimulate competition and hence business activities. Accompanied by sound economic policies and proper institutional arrangements, this should lead to an increase in domestic as well as foreign investment.

The new ACP–EU Partnership envisages contributing to the stimulation of foreign investment based on three key components. First, ACP countries should adopt domestic economic policies that will boost the confidence of foreign investors (section 2.1). Second, business initiatives (including investment) should be encouraged and the private sector should be fully associated with main policy decisions. In this respect, the Cotonou Agreement clearly differs from the four successive Lomé Conventions in that it recognizes the private sector (and civil society), together with Governments, as a pivotal partner for development (section 2.2). Finally, the negotiation of regional economic partnership agreements (EPAs), by creating larger markets and locking in policy reforms, should stimulate FDI (section 2.3).

2.1 Creating the appropriate economic environment

The Cotonou Agreement stresses the need to promote sound macroeconomic policies and to engage in structural policy reforms to provide a favourable business environment (CPA, Art. 22). These include:

- The control of inflation and budgetary balance through disciplined and transparent fiscal and monetary policies;
- The liberalization of trade policy and foreign exchange regimes;
- Current account convertibility;
- Labour market reforms; and
- The development of efficient financial systems, including for banking transactions, capital markets and financial services.

The development of business institutions (associations, intermediary organizations, chambers of commerce, etc.) and of instruments (finance provision, guarantee facilities, technical support) is also considered a key component of the development cooperation between the ACP and the EU (CPA, Art. 21). These institutions and instruments should help develop a business culture in the ACP, better exchange of information, improved entrepreneurial skills, technology and know-how. In sum, private sector development should stimulate domestic and foreign investment. These general objectives set out in the Cotonou Agreement help to determine the strategy of the aid component of ACP–EU cooperation (the European Development Fund), as well as to reinforce political commitments by the ACP countries to adopt appropriate market reforms and policies.

Beyond the general claim to promote an investment-friendly environment, the EU is committed, under the Cotonou Agreement, to providing specific investment support in several areas. These include tourism (and in particular for small and medium-sized enterprises (SMEs), where the Commission undertakes to support tourism development initiatives and investment support and promotion programmes (CPA, Arts. 23 and 24). It also pledges to support capacity-building initiatives with the establishment of investment promotion agencies to facilitate foreign investment and with the active promotion of an ACP–EU private sector business dialogue.

2.2 *Favouring private sector initiatives*

At the centre of the ACP–EU partnership approach lies the private sector. The Cotonou Agreement explicitly provides for the development of, strong cooperation with and active involvement of the private sector and civil society. Building on private sector initiatives, it aims at providing a comprehensive framework to stimulate investment in the ACP economies.

The recognition in the Cotonou Agreement of the key role of market forces and of the private sector as an engine for growth and development marks a major departure from the previous 25 years of exclusive Government-to-Government cooperation under the four successive Lomé Conventions. The Cotonou Agreement provides for an integrated approach to private sector development (at the macro-, meso- and microeconomic levels). It promotes an effective public – private sector dialogue and provides for support to structure and build the capacities of the representative private sector organizations. This includes support to measures to stimulate a business culture, to develop entrepreneurial skills, to strengthen business institutions, to foster transfer of technologies, know-how and best practices, to encourage inter-firm linkages and networking, and to promote business development through the provision of finance, guarantee facilities and technical support (CPA, Arts. 21 and 75).

The support to several private sector structures in the ACP include the reinforcing of the somewhat dormant Association of ACP National Chambers of Commerce, Industry and Other Economic Operators, and the development of the more promising ACP Business Forum. This latter organization, which started as an informal, bottom-up process, aims at regrouping ACP private sector actors to foster public – private dialogue and to effectively participate in the formulation, programming and implementation of ACP–EU cooperation at the national, subregional and overall ACP–EU levels.

A major innovation in the Cotonou Agreement is the new Investment Facility (INFAC), which marks an important shift from previous risk capital operations (CPA, Arts. 76 and 83.2.d). The Investment Facility, managed by the European Investment Bank, provides for euro 2.2 billion to be operated on market-related terms, from the 9th the European Development Fund for a duration of five years. The fund should become financially sustainable, as no further replenishment from EDF resources is foreseen. The aim of this fund, which focuses on the private sector, is to stimulate regional and international investment, to support the development of the private sector by financing projects and commercially viable enterprises and companies and to provide for the sustainable development of local financial and capital markets. Strict commercial conditions are set to provide risk capital in the form of equity and quasi-equity investments in ACP enterprises, guarantees and other credit enhancements in support of both domestic and foreign investments, as well as loans or lines of credits on concessional terms, to the benefit of small businesses, local financial institutions and enterprises in the process of being privatized.

Other initiatives available to the ACP private sector under the Cotonou Partnership Agreement to stimulate investment include:

- *DIAGNOS*, an institution dedicated to identifying constraints in the business environment and to designing programmes of support for the development of the ACP private sector;
- The *EU-ACP Business Assistance Scheme* (*EBAS*), which aims to increase the competitiveness of ACP enterprises and to strengthen the capacities of private intermediaries; and
- The *PROINVEST* programme, managed by the Centre for the Development of Enterprise, which is dedicated to facilitating and supporting investment promotion for ACP SMEs, intermediary organizations and private consultants.

Parallel to these measures to promote, finance and support investment (CPA, Arts. 75 and 76), the Cotonou Agreement also aims at providing investment guarantees and investment protection (CPA, Arts. 77 and 78 and Annex II, Art. 15). Investment guarantees and protection could be important tools to mitigate the perceived risk associated with investment. While the ultimate way to generate investor confidence so as to attract significant sustainable flows of domestic and foreign investment rests on the creation of a favourable economic environment and business-friendly climate, the availability of risk insurance schemes and investment promotion and protection agreements can provide useful safeguards for investment in the ACP economies.

However, we have to bear in mind that public risk insurance is usually financed out of budgets of economic or industry departments in developed countries and not out of aid budgets. If aid is nevertheless used to underwrite FDI to developing countries, we need to consider several issues in order to make financial guarantees work for development (not only for the investors):

- How can we be sure that financial guarantees (for political risk) are effective in leveraging *additional* investment in poor countries – that is, would investors have invested without guarantees?
- How can we be sure that the use of money for guarantees is more efficient than other uses of (aid) money? For instance, is the main obstacle good economic projects or financial capital, or a little of both?
- How can we be sure that guarantees for investment are being used for good projects that help to deliver (sustainable) development?
- What is the trade-off between imposing more stringent conditions attached to an investment and losing potential investors interested in guarantees?

- Could we identify countries, sectors, situations and so forth where guarantees work better (i.e. are effective)? For instance, sectors with large sunk costs and long-run required pay back times, or countries where reforms could lead to more productive projects, but where this information is not known to investors or rating agencies.

All these are issues on which there has been only limited research.

2.3 EPAs and investment: The role of regional integration

Trade and investment flows could also be stimulated by regional (and subregional) integration processes. Regional integration arrangements, by lowering regional barriers, can lead to the creation of larger markets. This, in a liberalized environment, should stimulate competition, leading to a more efficient allocation of resources according to the comparative advantages of countries. As a result, more trade among the members of a region and additional investment can take place.

This is basically the thrust of Article 1 of the Cotonou Agreement, which states that "regional and sub-regional integration processes which foster the integration of the ACP countries into the world economy in terms of trade and private investment shall be encouraged and supported". The support for regional integration in promoting cross-border domestic and foreign investment, as indicated in Article 29, is also one of the main justifications for the negotiation of new EPAs, or alternative trading arrangements, between the EU and the ACP, which started in September 2002.

According to the European Commission, negotiations on EPAs are much more than merely negotiations on securing preferential market access. They are about creating economic integration between the EU and ACP groupings, replacing, by 2008, the current non-reciprocal preferences in the trade relations between the EU and the ACP countries by WTO-compatible free trade agreements, based on reciprocity. EPAs

are also about enhancing "co-operation in all areas relevant to trade" (CPA, Art. 36.1), providing a stable, predictable and transparent policy framework for an enlarged market, which will increase competitiveness of the ACP economies. "To this end economic and trade cooperation shall aim at enhancing the production, supply and trading capacity of the ACP countries as well as their capacity to attract investment" (CPA, Art. 34.3).

To the extent that domestic and foreign investments are constrained by the size of markets, the creation of larger markets at the regional level can provide new business opportunities and thus generate more private investment, including that of foreign origin, to take advantage of economies of scale. Not only can regional agreements such as EPAs provide larger integrated markets, but also they may entail new national and regional policies and institutions that may affect the flows and effects of FDI.

EPAs can affect both inter- and intraregional FDI. They can affect inter-regional FDI through (external) tariff-jumping FDI, when lower trade barriers reduce the costs of establishing plants in a region compared with the costs of serving the same regional market by trade. The combination of lower internal barriers and significant production fixed costs can also lead to a consolidation of plants in several member States of a region into one plant, which is being used by the parent to serve the region as a whole. This may also induce FDI in the most cost-efficient location, usually nearest the largest market or the location with the better (transport) infrastructure, to supply the whole region. This redirection of further FDI flows may take place at the expense of other locations, in member States of the region where production is less cost-effective. Hence, as for trade, where regional integration can lead to both trade creation and trade diversion, possibly at the expense of not only countries outside the region but also some member States, regional integration can create winners and losers among countries of one region in terms of FDI attracted.

The type of regional agreements among ACP countries, and with ACP groupings and the EU, will have a determinant impact on the potential benefits from EPAs or alternative trade arrangements in terms of trade and investment flows and ultimately their effects on economic growth, sustainable development and poverty alleviation. The question for the ACP countries is whether the potential benefits in terms of investment promotion contained in the Cotonou Agreement and in particular EPAs could materialize, and under what conditions.

3. Issues for reflection

Clearly, investment in general, and FDI in particular, have an important role to play in the development of ACP countries. It is true that FDI can have ambiguous effects on the development path of some countries, with possible negative effects on the local economy. But on the whole, it tends to generate higher growth and productivity, which could lead to a reduction of poverty. Ultimately, the impact of FDI depends on the type of investment attracted and on the different policies and economic factors prevalent in the host countries. More research is definitely needed in this field in order to better understand the linkages between FDI and development.

ACP countries currently receive about as much FDI as official aid flows on an annual basis. In the future, however, the importance of FDI for the ACP economies is likely to increase. (Aid, by the EU and the United States, is also expected to increase according to recent announcements.) This is one of the underlying objectives of the Cotonou Agreement. The new ACP–EU partnerships are intended to develop stronger linkages between the public and private sectors, and to foster a business-friendly environment in ACP countries that should encourage both domestic and foreign private investments.

While the principles of the Cotonou Agreement seem to be sound, the effectiveness of its provisions relating to

investment remains to be seen. Implementation is a serious concern. Building capacity for private sector development and setting the right economic environment are a long-term and resource-consuming exercise which will need the strong political support of both EU and ACP decision makers.

To gain more insights into the potential overall effect on investment of the Cotonou Agreement, it is necessary to (a) systematically examine the scope of the provisions related to investment and identify how they differ from those of the previous Lomé Conventions; (b) to assess the usefulness and effectiveness of the measures contained in the Lomé Conventions; and (c) on the basis of the lessons from the Lomé Conventions, to examine the potential effects of the relevant provisions in the Cotonou Agreement on experience so far and of the institutional settings and programmes already in place.

Another issue of concern relates to the effective impact of EPAs on FDI. The European Commission seems to rely on the potential benefits of regional integration in ACP countries and the regional EPAs. This can be explained by the rather successful European history with its own economic integration process. As a consequence, the EU seems to have adopted regional agreements as *the model* of closer economic relations with its partners.

However, there are no studies that systematically address the effect of economic integration on FDI after controlling for various factors affecting FDI. Theory suggests that increased investment can be a benefit from integration, but this has not been put to the empirical test for South – South integration. Besides, can regional integration increase FDI in poor countries, including the poorest of an ACP region? Currently, large ACP countries such as Nigeria receive a large share of FDI. Will the further integration of ACP regions and the creation of regional EPAs attract more FDI for all regions and countries or only for some regions and countries to the detriment of others? Will some member countries of a region, most probably the more

developed ones, attract most of the FDI at the expense of their poorer partners?

Similarly, can different types of regions be distinguished with respect to how they affect FDI inflows from outside the region? And do the effects of forming regions amongst developing countries on attracting FDI depend on the type of regional integration advancement in integration, and the position (core/periphery, relatively more and less developed) of host countries in the region? If only certain types of regions attract more FDI, this has direct consequences for the process of creating and adjusting regional institutions and provisions intended to attract FDI. Similarly, if some countries in a region do attract more FDI at the expense of others, adjustment policies and complementary measures need to be put in place.

It is therefore essential that these questions be thoroughly investigated so that the necessary information and guidelines for effective implementation of the Cotonou Agreement can be provided. Moreover, such information will be of vital importance to the policy makers in charge of negotiating new trading arrangements between the ACP and the EU, such as (regional) EPAs or possible alternatives. It is only on this condition that proper policies and frameworks can be put in place to foster FDI that will benefit the ACP countries and contribute to their sustainable development.

Policies to promote the development dimension of FDI

Gunnela Becker

This short note on the role of policies in fostering the development dimension of FDI is divided into three sections: host country measures, home country measures and the right to regulate. The emphasis, however, is on the second section.

1. Host country measures

It may be useful to consider some "dos" and "don'ts" in the context of host country policies. Host and home countries have a common interest in providing a sustainable environment for FDI. The route of an incentives race is associated with important risks, and the same is true for the use of most performance requirements. Trade and investments are always mutual issues of confidence or trust between commercial partners. Governments have a key role in fostering the creation of legal and administrative structures that can provide confidence in both public and business relations. To give one example, the problem of corruption is a global one – not only a responsibility of the developing countries.

Let us first consider some "dos". In host countries, a non-discriminatory, stable and predictable trade and investment environment will have to be created. Such an environment contains a number of elements of importance. Customs administrations, tariffs, trade procedures and taxation are just a few examples. They all need long-term assistance and solutions. Protection of the intellectual property of investors is an important investment incentive. An adequate and non-discriminatory competition policy is similarly necessary, especially from the perspective of host countries, in order to prevent misuse of dominant position – by any company on the market, whether foreign or domestic.

With regard to "don'ts", countries may be advised to avoid certain elements in their policy approach. First, a subsidies race is typically both discriminatory and expensive. Second, a lowering of domestic standards to attract investors is a bad solution for all. Third, any host country rules or regulations that may risk making investments less effective are also a poor solution. Developing countries need investors who want to stay and use – thereby also transferring – their technologies on a long-term basis. Consequently, post-investment protection should be a priority for both parties. All these issues call for multilateral solutions.

Finally, while the market size may have become less important as a determinant of the location of FDI (as argued by Professor Kokko in this volume), it remains a key factor. Therefore, regional integration agreements, compatible with the WTO, may also be a tool for enhancing the investment climate by providing a larger market size, possibly complemented by the use of a common currency.

2. Home country measures

On behalf of the Swedish Ministry for Foreign Affairs and the Swedish International Development Cooperation Agency (SIDA), I recently concluded a first brief study[1] related to possible ways of enhancing transfer of technology to the least developed countries as stipulated under the Agreement on Trade-Related Aspects on Intellectual Property Rights (the TRIPS Agreement), of the World Trade Organization (WTO). This is an area in which the Government of Sweden is currently considering various ideas and opportunities. My comments below are provided on a personal basis and do not necessarily represent the official Swedish standpoint.

[1], Gunnela Becker, *Transfer of Technology and the TRIPS Agreement – A Study of Article 66.2 in the WTO/TRIPS Agreement*, paper prepared for the Swedish International Development Cooperation Agency, mimeo, September, 2002.

When working on the study, I came up with a number of ideas for home country incentives and measures to promote the transfer of technology in the context of the TRIPS Agreement. Many of these ideas are relevant also in the FDI context.

It is striking that, in spite of the implementation of the TRIPS Agreement in general; there has so far been very little action on the transfer of technology commitments. Thanks to some persistent and articulate LDC delegates to the WTO, however, things are now starting to move ahead. From this, and from analysing the TRIPS Agreement, we can learn a number of things of relevance to the multilateral investment context:

(a) LDCs can certainly have an impact in the WTO, both in negotiations and in the day-to-day work of the organization.

(b) It proved very wise from the LDC point of view for the technology transfer commitment in the TRIPS Agreement to be of binding nature. This resulted in a further decision at Doha on the implementation of a monitoring mechanism. A continuing dialogue is thereby secured.

(c) The TRIPS Agreement is interesting because of its unique private sector and investment linkages. This calls for real private – public interaction.

(d) There must be a serious interaction between home and host countries for home country measures to be effective. This is, at least in my view, recognized in the wording of Article 66.2 of the TRIPS Agreement.

On home country measures, more broadly, I would like to make the following general suggestions:

(a) There may be a case for initiating discussions, under the WTO Agreement on Subsidies and Countervailing Measures, on the possibility of explicitly allowing for certain home country subsidies that are designed to promote transfer of technology (and investments) to LDCs.

(b) Governments in developed countries should set a good example by taking their WTO commitments seriously. The TRIPS commitment on transfer of technology does not mean "best endeavours". It means an obligation to provide incentives for technology transfer.

(c) A first step would be for Governments to formally instruct, in writing, their relevant public entities to allocate part of their annual budgets to measures that could stimulate technology transfer to LDCs.

(d) The entities thus instructed would subsequently be obliged to report back to their Governments on action taken. They should also be required to evaluate the effectiveness of their measures.

(e) This should trigger cooperation between all national institutions and agencies involved, as well as a dialogue with the private sector. Home country measures must be designed so as not to disrupt normal commercial trade.

(f) The essence of this is that technology transfer and outward FDI incentives must be subject to good governance in the home country. Good governance is certainly an issue for all countries.

Financial incentives are mostly sensitive from a competition point of view. But perhaps they need not be ruled out altogether. The experience of the Swiss Organization for Facilitating Investment is interesting in this respect. We have similar activities on a small scale in Sweden through what are called the "Start South" and "Start East" programmes managed by SIDA.

However, there may be alternative options. The following suggestions are primarily aimed at home country support for technology transfer to LDCs and perhaps also other low-income countries:

(a) Independent mentoring and coaching on innovation and business management, for example in the art of commercializing an innovation or approaching investors and venture capitalists.

(b) "Venture Cup" competitions in LDCs in order to promote innovations and investments in the most useful technologies, perhaps in cooperation with international development banks for financing.

(c) Special "Venture Cup" events in home countries for technologies that fulfil urgent development needs, preferably combined with preferential venture capital conditions for investments in least developed countries.

(d) A "Connect Model" for the LDCs. Through this model, an individual entrepreneur from an LDC could have access to a "springboard exercise" in front of a panel of experts from the home country (or countries). The panel members participate under non-disclosure agreements. They provide individual strategy advice on the innovation and business concept from a multitude of commercially interesting angles. The "springboard" could also include links to investors and venture capitalists. It could be organized as part of a business development seminar for participants from several LDCs, arranged in a home country. The Connect model, with its origin in San Diego, California, is now available in many countries. However, as far as I know, there is as yet no LDC variety of the kind just suggested.

(e) Support for less expensive and better use of the Internet, for example through adequate information technology (IT) infrastructure measures. A particular challenge is to adapt solutions to the low-income countries concerned, otherwise investments may prove useless. This would significantly enhance business and investor relations, network building and so forth. It would also make a considerable contribution to attracting more investments. IT must now be regarded as a basic transport and communication infrastructure for a functioning market economy.

(f) Administrative and legal systems that provide a transparent, stable and predictable investment climate are of paramount importance for attracting investors. Home countries could assist by providing or financing education on good business and institutional governance. Such assistance should include customs administrations and procedures, competition laws and policies, patent systems and other legal systems, financial services of various kinds, environment protection, and more. In the WTO context, it is important to note that these countries may need new regulations rather than de-regulation. Measures of these kinds will not only help to attract FDI but will also contribute to making them sustainable. Such incentives are certainly preferable to host country financial incentives to attract investors. The latter cost money but do not necessarily bring forth any long-term benefits for the host country.

(g) Home countries could support good public and enterprise knowledge management or competency strategies. This would contribute to sustainable technology transfer and investments.

Finally, a suggestion for a solution that might be politically interesting and would make sense from trade policy, development, intellectual property rights and commercial points of view. Home countries could, upon individual or joint initiative, establish an independent international foundation for humanitarian technology transfer. Its funding should be as global as possible and the foundation should be given considerable publicity in order to attract funding. The main idea would be to support, in a competition-neutral fashion, humanitarian transfer of technology licensing. Financial incentives dealt with by such an institution would be much less controversial than home country financial incentives for individual enterprises. However, home country incentives that are compatible with the WTO rules could interact in a positive way with the foundation.

The foundation could attract donations – of money or patents. It could also provide a forum for research, analysis and development of technologies of humanitarian interest (but not necessarily in practice carried out by the foundation itself). The foundation could initiate and evaluate technology transfer projects. It could operate as a forum and knowledge bank. The foundation could combine technical assistance, technology transfer and commercial networks, for example with investors.

3. Right to regulate and safeguards

The right to regulate should be recognized in the interest of both host and home countries, and traders and investors. There are close relations between trade and investment. It is certainly not a question of either/or, but both. Therefore, the rules must be compatible. The contribution by Professor Trachtman in this volume, drawing on WTO rules of relevance to a future agreement on investments, is very interesting in this respect.

To adopt sound regulation for sustainable development is not as easy as it sounds. The right to regulate must not mean the freedom to introduce any kind of non-transparent, discriminatory, non-predictable regulations. From a long-term perspective, host Governments may "shoot themselves in the foot" by driving away investments through such measures.

The GATS and the TBT Agreement are examples of a new trade policy environment where the art of domestic legislation is coming more and more into focus. It is a concern for both developed and developing countries to seek the right balance between "hands on" and "hands off" in this regard, in the interest of their enterprises and citizens. Measures should therefore be balanced in order not to be unduly restrictive with regard to their purpose.

We all need and benefit from sound regulations, but we normally have very little to gain from undue or discriminatory

protection against international trade. We all need to look for regulatory techniques that are the least trade- and investment-restrictive, whilst ensuring the necessary protection of citizens. But it is not in the interest of citizens to pay for the protection of business that is not sound and competitive in the long term.

To draw a parallel trade in goods: anti-dumping measures, for example, more often than not actually cause harm to, rather than help, the private sector in the country where they are introduced.

In the context of international investment agreements, if safeguards are really needed – which has not yet been proved – it is important to look for measures that do not rebound on the host country itself or its international relations. After all, foreign presence is mostly beneficial to the host country.

Among measures that will certainly hurt not only investors but also the long-term interests of host countries, the following in particular may be mentioned:

- Negative post-investment changes, such as expropriation (any investor would need a guarantee against both direct and indirect expropriation); and
- Insufficient notice when new regulations are implemented (it will soon make foreign investors withdraw).

A good competition policy may also be a tool for ensuring that domestic enterprises are not adversely affected by a foreign enterprise's too dominant role in the host country market.

The application of home country law in the host country, as suggested by some speakers during the Expert Meeting, does not provide a level playing field. It is simply discriminatory. A better idea may be a long-term partnership between a home country and a host country in order to define regulatory needs in tandem with development needs.

PART III

Corporate social responsibility

Corporate social responsibility for international business

Sol Picciotto

The recent proliferation of corporate social responsibility (CSR) codes and standards has been matched only by the boom in writings on the subject.[1] This paper will focus mainly on the interaction between these codes and formal legal requirements at national and international levels. It starts from the perspective that the recent spate of voluntary corporate codes for TNCs must be understood in the context of the changing environment for FDI, including shifting patterns of national and international regulation. Hence, although corporate codes have a legitimate place, it suggests that they should be more firmly anchored within a broader regulatory framework which establishes obligations as well as rights for business. This could be based on new approaches to combining binding "hard" law with non-binding “soft” law standards, notably through a framework convention.

1. Business rights and responsibilities

International business in various forms has a long history, and even the currently dominant form of the transnational corporation (TNC) goes back to the end of the 19th century. However, it is only since the 1960s that there has been an increasing tension between the global reach and visibility of TNCs and the dualist hierarchy of national-international law. This regards corporations as formally private legal persons, and hence subjects of national law, while international law directly binds only States. However, the size and importance of TNCs made them a prime target for regulation in both home and host States. This exposed them to multiple and sometimes

[1] A notable recent collection is Jenkins et al. (2002).

conflicting regulatory requirements, which came to the fore in the 1960s. In a period of lively debate a variety of proposals were put forward. Perhaps most radically, George Ball, a United States Under-Secretary of State and United Nations representative (later Chairman of Lehman Brothers International), proposed the "denationalization" of TNCs. He argued that a supranational citizenship for TNCs should be provided by treaty, since in his view the pragmatic policy followed by TNCs of obeying local laws in each country where they operate would not resolve the "inherent conflict of interest between corporate managements that operate in the world economy and governments whose points of view are confined to the narrow national scene" (Ball 1967, 1975).

Ball's proposal remained an abstract one, and instead a more piecemeal approach was adopted. Pressures to adopt global standards of responsibility for TNCs were generally channelled into the formulation of non-binding guidelines or codes by intergovernmental organizations (UNCTAD, 1996). Some had a broad scope, such as the ILO Tripartite Declaration of 1977, the OECD Guidelines of 1976, and the aborted United Nation Code of Conduct for TNCs; others had a more specific regulatory focus, such as the Set of Principles for the Control of Restrictive Business Practices of 1980; and some were aimed at specific industry practices, such as the WHO's Baby-Milk Marketing Code of 1981 (Picciotto, 1999; Richter, 2001).

Not surprisingly, the impact of these instruments greatly depended on the effectiveness of the mechanisms for monitoring and ensuring compliance, and especially on the strength of social pressures brought to bear mainly through civil society organizations (trade unions and other social movements). Too often the fact that they were not legally binding was used to justify a failure or even refusal to back up these codes with adequate procedures for monitoring compliance or dealing with alleged violations. Thus, "non-binding" was assumed to mean "aspirational", which is not at all the same thing.

In the meantime, States sought to define and assert their sovereignty to regulate economic activities taking place within their national jurisdiction. Capital-importing host States, especially the developing countries (many of which had recently gained political independence), sought to attain economic independence by asserting their right to control foreign investment. This was most strongly expressed in the Charter of Economic Rights and Duties of States (CERDS) of 1974. Article 2(a) of the CERDS asserts the primacy of national jurisdiction and denies the existence of any obligation to grant "preferential" treatment to foreign investment. This expressed the formal right of States to assert total regulatory power over economic activity within its borders, including acquiring or limiting ownership rights.

Not surprisingly, international investors and their home States became wary of the intentions of host States. Bilateral investment agreements (BITs) emerged as a means of providing basic guarantees. However, on the whole they did not restrict the direct regulatory powers of host States. Most BITs permit the host State to regulate entry, impose ownership limitations or conditions, and specify performance requirements (Dolzer and Stevens, 1995). Indeed, one analyst has described them as embodying "nationalism behind a liberal façade" (Vandevelde, 1998a; see also Vandevelde, 1998b). This explains the willingness of developing countries to negotiate such agreements, since they continued to consider controls over inward investment important to ensure that it contributes to economic development, as evidenced in the success of the East Asian developing countries, including China.

During the 1980s, however, pressure grew for countries wishing to attract investment to adopt a completely "open door" policy, and to abandon access controls, ownership restrictions and performance requirements. This stance was embodied in the United States model BIT of 1980, which required pre-entry national treatment (although this was subject to specific exclusions in actual treaties negotiated). Capital-importing countries continued to resist these pressures, and rejected

suggestions that a multilateral investment treaty be included in the Uruguay Round of trade negotiations, which resulted in the establishment of the WTO. However, the negotiation of BITs gathered momentum in the 1990s (UNCTAD, 1998), and some of these treaties conceded pre-entry national treatment.[2]

In the meantime, the attempt to develop a multilateral agreement on investment (eventually known as the MAI) shifted from Geneva to Paris, where the negotiations were hosted by the OECD, only to be abandoned in failure after three years in 1998. It was apparently a surprise to some that even developed countries, which account for the bulk of international investment, and are generally both exporters and importers of capital, failed to agree a strong investment liberalization and protection standard. However, a major reason for the difficulties encountered by the negotiating Governments, exacerbated by the criticisms from an internationally organized campaign and articulated by their increasingly concerned domestic constituencies, was the realization of the potentially far-reaching deregulatory impact of this type of treaty. This resulted in growing lists of national exclusions, as well as more general carve-outs in the agreement itself, negating its intended purpose of establishing a high level of market access and investment protection (Picciotto, 1998). At the same time the eruption of the financial crisis in Asia in 1997, spreading also to the Russian Federation, drew attention to the dangers of rapid liberalization of investment flows.

The slogan "No Rights without Responsibilities", adopted by campaigners against the MAI (Mabey 1999, 65), encapsulated the criticisms levelled by many observers of the emerging regulatory framework for international investment.

[2] By December 2000 the United States had negotiated 41 such treaties, 31 of which had been ratified. The Russian Federation had not yet ratified the treaty signed in 1992, and none of the rapid-growth economies in East Asia and Latin America had ratified a BIT with the United States, with the exception of Argentina (in 1991, entering into force in 1994): see http://www.state.gov/e/eb/rls/fs/1139.htm, and for an updated list www.tcc.mac.doc.gov.

The pressures towards economic globalization were resulting in legally binding restrictions on national state regulatory powers. These entailed not only the removal of border controls on admission of investments, but also granting foreign investors legal rights to challenge domestic laws by alleging de facto discrimination, or on the grounds of the taking of a property right. The increase in these legal challenges, brought under both BITs and NAFTA's chapter 11, demonstrated the willingness of some investors to devote large resources by resorting to international law to block or overturn national State actions.

Yet international law had developed few if any instruments governing the responsibilities of international business. Only in 1997 did the OECD agree a treaty to combat bribery of foreign public officials, although a draft had been developed through the United Nations in 1979 (UNCTAD, 1996, I-103). The bulk of the instruments developed since the 1970s to establish standards of responsibility for international business not only remained non-binding in form, but also were generally supported by weak mechanisms for monitoring compliance. This was the background to the emergence in the late 1990s of corporate codes.

2. Corporate codes: Effective tool or performance risk hype?

The sudden spate of adoption of corporate codes from the mid-1990s took many by surprise, and raised new questions for both critics and defenders of big business. The mantra of liberalization suggested that if business were left free to pursue profit, economic growth and social development would follow. Yet here were companies voluntarily committing themselves to a wider range of social and environmental goals. It was quickly apparent, however, that this did not originate from simple altruism on the part of their directors, but from an awakened awareness of the importance of the firm's image to its customers, workforce and investors. Reputational damage could quickly hit bottom-line profits, while investment in social responsibility could reap long-term benefits.

Some learned this lesson with a dramatic suddenness. A notable case in point was Royal Dutch Shell, which in 1995 suffered a double blow. The company's decision to end the life of its Brent Spar oil platform by sinking it in the North Sea was exposed to the media spotlight by a dramatic stunt by Greenpeace, although the activists' denunciation of Shell's environmental irresponsibility was later felt to have been exaggerated. On the other side of the world, a campaign by the Ogoni people in the Niger delta, culminating in the Nigerian Government's putting to death of nine of their leaders, including the writer Ken Saro-Wiwa, drew the world's attention to the company's apparent indifference to the environmental damage and social deprivation which its highly profitable activities did nothing to alleviate, and seemed indeed to exacerbate. By April 1998, the firm produced the pioneering *Shell Report 1998*, subtitled "Profits and Principles – Does There Have to be a Choice?", which stated it was about values. It describes how we, the people, companies and businesses that make up the Shell Group, are striving to live up to our responsibilities – financial, social and environmental. These were the three dimensions of the so-called "triple bottom line" of sustainable development, against which Shell proclaimed that all companies would soon be expected to account for their activities. Shell went even further in recasting its annual report for 2000 entirely in terms of of social responsibility and health, safety, and the environment (Williams, 2000).

Shell's experience showed that it was not enough for a firm, especially a large TNC, to manage its operations simply in compliance with the law, and leave it to Governments to deal with social issues in the public interest. The decision to sink the Brent Spar complied with all the regulations agreed among the States bordering the North Sea. The failure of oil wealth to benefit ordinary people, especially in the oil-producing regions in Nigeria, could be attributed to the distribution formula which allocated the bulk of revenues to the central Government, where it was dissipated in corruption (Frynas, 2000; Wheeler et al., 2002). None of this protected the company from consumer boycotts and loss of employee morale resulting from damage to

its reputation. As one commentator put it, "close observers of Shell have said the company's reaction to those crises was not that they were temporary unpleasantries to be weathered but truly corporate culture-altering events that shook the staid old giant to its core" (Williams, 2000).

Shell's experience was replicated by other companies sensitive to consumer concerns and reliant on brand names, for example in the apparel industries and retailing. High-profile campaigns on United States campuses targeted firms such as Nike and The Gap for their use of supply-chain subcontractors employing workers who were often under age and in sweatshop conditions. Incidents such as the fire in 1993 at the Kader toy factory in Thailand, which supplied major toy companies, and videos showing children in Pakistan's Sialkot stitching footballs with a FIFA label prior to the 1996 World Cup, were used by international trade union organizations to highlight breaches of international labour standards (Justice, 2002). Firms found that the brand names trusted by consumers, which were often their most significant asset, could quickly be endangered by campaigns which revealed the "labour behind the label" (Klein, 2000).

Within a short space of time many companies and industrial associations had adopted voluntary codes. An OECD study collected some 246 codes, about half of which were issued by individual firms, and some 40 per cent by associations, the remainder mainly by stakeholder coalitions and NGOs (OECD, 2000). They generally dealt with matters of concern to consumers, such as labour and environmental standards, as well as compliance with the law, and issues of potential risk to the firm, such as bribery and corruption. There were, however, considerable variations both of subject matter and of style, especially in the degree of specificity.

This revival of interest in establishing global standards of corporate responsibility once again drew in intergovernmental organizations. Thus, the United Nations Secretary-General, Kofi Annan, in a speech to the World Economic Forum in

Davos on 31 January 1999, challenged world business leaders to "embrace and enact", both in their individual corporate practices and by supporting appropriate public policies, nine universally agreed values and principles derived from United Nations instruments, which were embodied in a United Nations Global Compact (www.unglobalcompact.org). However, this initiative was in turn criticized by activists as no more an attempt to lend the legitimacy of the United Nations to corporate public relations hype (TRAC, 2000). The International Labour Organization has also become involved, especially in relation to labour standards, and has established a business and social initiatives database (www.ilo.org/basi).

The private and voluntary nature of these initiatives raised two central questions. These were the rather haphazard and selective content of the codes, and the lack of effective implementation mechanisms or procedures for monitoring compliance. Thus, an analysis by the ILO of labour-related content in approximately 215 codes showed that the majority (especially of enterprise-drafted codes) used self-defined standards; reference to national law was relatively frequent especially in relation to wage levels; but no more than one third referred to international labour standards even in general terms, and only 15 per cent (almost exclusively those developed with trade union or NGO involvement) referred to freedom of association and/or collective bargaining (ILO, 1998, para. 46ff). The OECD study showed only 13 per cent of the codes referring to labour issues mentioning ILO standards, and 30 per cent freedom of association (OECD, 2000, para. 18–19).

As regards implementation, the bulk of corporate codes rely on internal follow-up and monitoring (OECD, 2000, para. 85). Even where there is provision for external involvement, for example in third-party or industry-association codes, critics have raised serious doubts as to whether this is genuinely independent. Lack of effective implementation was the main reason for refusal of trade unions and some NGOs to join the United States Fair Labour Association (Jenkins et al., 2002, 24). Private management consultants have of course been quick to

offer their services for compliance auditing, but doubt has been cast on both their independence and competence (LARIC, 1999; O'Rourke, 2002). On the other hand, NGOs have been wary of being drawn into this role, for fear of becoming co-opted and merely lending their legitimacy to corporate public relations (Kearney, 1999). The ILO's survey document raised the possibility of its adopting a proactive role, towards both specification of the content of codes and verification procedures (ILO, 1998, para. 138), but in practice it has adopted the minimalist alternative of providing advice and information (ILO, 2003).

The self-selected nature of the content and the lack of independent external implementation or monitoring mechanisms inevitably generate scepticism about the value and effectiveness of corporate codes. Although serious study of the effects of codes is still in its infancy, there is some evidence that firms adopting a code do not perform any better against benchmarks relevant to that code's standards.[3]

Public scepticism about corporate codes has been further fuelled by the startling revelations of unscrupulous behaviour on a massive scale by senior managers, following the dramatic collapses of corporate giants such as Enron and WorldCom and the crash which followed the dotcom bubble. The inquiries into Enron, for example, revealed that a combination of financial engineering and sophisticated tax avoidance enabled it to declare in its financial statement between 1996 and 1999 net income of $2.3 billion, but losses for tax purposes of $3 billion (McIntyre and Nguyen, 2000; United States Congress, 2003, 6). Significantly, only one of the codes analysed in the OECD study mentioned taxation (OECD, 2000, para. 29). This loss of public confidence in corporate management has so far led mainly to proposals to strengthen corporate governance mechanisms, especially in the United States.

[3] See notably the study by King and Lenox (2000) on the chemicals industry's Responsible Care programme.

3 Embedding voluntary codes in law

Much of the discussion of corporate codes is based on the assumption that by definition they exist outside or beyond law. Their advocates stress that their strength lies in their voluntary character, which gives them the flexibility to be tailored to the characteristics and circumstances of the business, and to raise standards by encouragement and self-generated commitment, as opposed to the rigidity and instrumentalism of externally imposed and bureaucratically enforced law. Corporate critics and sceptics, on the other hand, challenge the effectiveness of self-selected and self-monitored standards.

On closer examination, this sharp distinction between voluntary codes and binding law can be seen to be inaccurate, undesirable and unnecessary. Codes entail a degree of formalization of normative expectations and practices and, even if they do not directly take the form of law, they may have indirect legal effects. The challenge is to design a framework or architecture which can combine the strengths of corporate codes and formal law. Codes may have legal effects in a number of ways.[4]

Firstly, they may be enforceable through private law. For example, they may constitute or form part of contractual agreements. This may be the case where a firm formulates a code for its business networks, for example a brand-name retailer for its sub-contractors and suppliers, or a major oil company such as Shell for its retail outlets. Typically, companies have in practice preferred to avoid such effect, by specifying that these codes are not intended to be formally legally binding. However, it is also generally made clear that if identified breaches of the code are not followed up by remedial action, they would lead to non-renewal of commercial contracts (Fridd and Sainsbury 1999, p. 231). In addition, obligations to facilitate monitoring of compliance may form part of the formal

[4] A literature survey focusing on national laws, especially in Europe, is provided by Jülich and Falk (1999).

commercial contract. Associational and third-party codes are also likely to have effect as contractual arrangements, under which participating firms may be entitled to certification (which can be used in their product and brand-name marketing) provided that the agreed monitoring mechanisms verify that they comply with the provisions of the code.

This flexible relation between formally binding legal obligations and more specific standards, which in practice determine when to invoke the law, is a familiar concept. It has long been known that breaches of formal contractual obligations in business agreements are often dealt with flexibly (Macauley, 1963). Hence, the formally non-legal status of supply-chain codes should not in itself be a concern, unless it is a signal that the code is not intended to be taken seriously.

Codes may also lead to legal enforcement by private parties based on national State regulatory law. For example, firms proclaiming their adherence to a code create expectations which may be legally enforceable by their customers or other stakeholders. Thus, the California Supreme Court has allowed an action to be brought against Nike for breach of false advertising and unfair competition laws. The action challenges the accuracy of the report commissioned by Nike on compliance with its corporate code by suppliers, and used in Nike's corporate publicity, which had found no evidence of illegal or unsafe working conditions in Nike factories in China, Viet Nam, and Indonesia (Kasky v. Nike, 2002).

At the level of international law also, voluntary standards or codes can be given a legally binding status. For example, the World Trade Organization (WTO) agreements on technical barriers to trade (TBT) and on sanitary and phytosanitary measures (SPS) establish an obligation on States to use relevant standards developed by appropriate international organizations "as a basis for" national regulations affecting internationally traded goods. This has the effect of converting standards developed by organizations such as the Codex Alimentarius Commission, which those bodies themselves do not regard as binding, into mandatory obligations for WTO members.

Thus, there is no rigid separation between "soft" and "hard" law, between totally voluntary codes and strictly binding laws. The interesting and important question therefore is how to construct an "architecture" of normative arrangements which can combine and integrate the two in the most fruitful manner. This requires first an analysis of the strengths and shortcomings of each, and then an evaluation of the different forms of combination.

Analysis of corporate codes, briefly surveyed above, suggests that they have two main advantages. Firstly, they can be tailored to meet the specific needs of particular businesses, and applied with awareness and sensitivity to their particular circumstances and local context. For example, rigid laws strictly applied may be a harmful way to tackle the problem of child labour in poor communities and countries. A simple prohibition against employing children below a certain age may merely result in their being excluded from relatively better-paid jobs in the formal sector and forced to resort to work which is physically and morally much more damaging. Thus, the United Kingdom's Ethical Trading Initiative Base Code requires adherents to end new recruitment of child labour, but also to develop or participate in and contribute to policies and programmes which provide for the transition of any child found to be performing child labour to enable her or him to attend and remain in quality education until no longer a child. This suggests that laws should establish minimum acceptable requirements, while codes should be aspirational and aim at significant enhancement, as well as providing constructive arrangements for achieving such improvements.

The flip side of this flexibility, however, is one of the significant disadvantages of codes, their patchy and uneven content, resulting from self-selection. Hence, an important function for the broader governmental and intergovernmental codes (such as the United Nations Global Compact) is to provide a template of the basic principles of CSR, which to some extent they are already performing. However, this has not been expressed as establishing either a basic minimum or as

taking the form of binding requirements. Thus, the flexibility and adaptability of the code format may result in firms picking and choosing from among the standards, effectively diluting them, instead of building more specific provisions and targeted programmes onto them.

This suggests that formal law could play a helpful role in defining minimum standards or templates for the content of codes. These could be amplified or specified in more detail by firms, to tailor the standards to their own circumstances. In this way, corporate codes could provide real value-added, instead of tending to dilute the standards applicable.

Legal frameworks for regulating corporate codes could be established at national, regional and global levels. An example of a national law is the proposal submitted to the Australian Senate in 1998 for legislation to require Australian TNCs to report on their compliance with a range of defined CSR standards.[5] The rejection of this proposal perhaps indicates some difficulties with the approach it adopted. Firstly, it adopted a prescriptive approach by seeking to define directly the CSR standards on which firms should report compliance. This would tend to result in minimalism, a least-common-denominator definition of standards. For example, although the Bill did include a provision on taxation, it was limited to a duty "to comply with the tax laws in each country in which it operates". As suggested above, a better approach would be to require firms to draw up their own codes, but on the basis of a minimum specification. Thus, in addition to compliance with national tax laws, firms could be required to establish guidelines to prevent tax avoidance, which could be tailored to their particular type of business and their international structure. Similarly, it is better to ask firms to establish environmental impact assessment and environmental performance standards for themselves, adapted to their own business, while requiring them to be based on required minimum specifications.

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[5] Parliament of the Commonwealth of Australia, draft Corporate Code of Conduct Bill (1999-2000, no. 1878), presented by Senator Bourne.

The second problem with national requirements is the issue of jurisdiction. A home State which requires specified standards to be complied with not only by companies incorporated under its laws or in respect of activities within its territory, but also by foreign affiliates and for activities abroad, may be accused of excessive or "extraterritorial" claims to jurisdiction. However, the law need not be blind to business reality. Obligations can clearly be placed on the parent company, and its directors, which can extend to the worldwide activities of the firm, to the extent that these activities are under their de facto control.[6] By requiring parent companies within their jurisdiction to establish CSR standards for the worldwide activities of the integrated firm, home countries would be encouraging such firms to spread best practice internationally, which could be regarded as legitimate.

Nevertheless, it would be easier and in many ways more desirable for such requirements to be agreed internationally as far as possible, so that national law can be based on international agreement. Here again, a new approach seems to be needed. Intergovernmental organizations have faced the dilemma, since the initial movement in the 1970s to develop codes of conduct for TNCs, that they have no power to create legal obligations binding directly on firms. Mainly for this reason, measures such as the OECD Guidelines for Multinational Enterprises have taken the form of "recommendations jointly addressed by governments to transnational corporations". At the same time, they have been formulated in fairly abstract and general terms.

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[6] This approach has been adopted by some courts in considering private law claims of liability of a parent company for injuries caused by activities carried out through foreign subsidiaries. It is much easier to accept that home country courts should have subject-matter jurisdiction if the claim is based on the direct liability of the parent (due to the knowledge of the company and its directors and managers of the dangers involved in the activity in question), rather than vicarious liability based on the ownership relation: see *Lubbe et al. v. Cape Industries* (2000). Compare also the consent decree in *The Amoco Cadiz* (1984), which implied that if a firm is operated as an integrated whole, the parent company could be presumed to have knowledge of and involvement in the activities which caused the damage.

However, it is notable that codes with a more specific focus have been more detailed and specific: a case in point is the WHO Code of Marketing of Breastmilk Substitutes. This indeed has been used by some States as the basis for national legislation. Where it has been felt necessary to establish binding legal obligations, these have been directed at States, and tend to be expressed in minimalist terms even if their focus is specific. Thus, the OECD's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (1997) has a rather narrow scope, although it is backed up by a process of peer review implementation.

An alternative approach could adopt the technique of a framework convention. This has emerged in recent years as a means of establishing a set of objectives and principles which are binding on States, together with implementation mechanisms and processes for the formulation of more specific norms. Initiated for the purposes of developing regimes for environmental protection (such as climate change), the technique has been adapted by the WHO for its proposed Framework Convention on Tobacco Control (Bodansky, 1999). Its advantages are that it can establish an organizational and procedural basis to develop new standards, as far as possible through deliberative processes involving a range of civil society as well as governmental participants, providing a stronger basis for mutual trust.

A framework convention can also adopt a more flexible approach to combinations of hard and soft law codes. For example, it can establish legal requirements for participating States to lay down specifications for corporate codes in general terms, while providing that they should be based on appropriate internationally agreed standards which may be developed subsequently. As explained above, the WTO agreements establish a framework convention in this sense, since they require States to ensure that national regulations do not create unnecessary obstacles to trade by "basing" them on internationally agreed standards where they exist.

4. Integrating CSR measures within a global rules-based framework

The example of the WTO can also be adapted to deal with the criticism that international investment agreements are one-sided in granting significant rights to investors without any responsibilities. This has raised the question of how a better balance might be achieved in a multilateral framework for investment. A framework convention could provide an umbrella for a number of related agreements which would deal with both investor rights and responsibilities, combining liberalization and regulation.

The technique of related agreements could be used, firstly, to clarify the impact of investment protection obligations on national law. As with the TBT and SPS agreements under the WTO, a presumption could be created that national measures based on internationally agreed standards (e.g. of environmental protection, or human rights) would be valid. This would help to prevent disputes or claims based on indirect discrimination or de facto expropriation.

Secondly, international agreements and standards could be associated within a multilateral investment framework on either a required or a conditional basis. Some international instruments might be considered to embody such core values and standards that they should form an essential part of the package, just as the Agreement on Trade-Related Aspects of Intellectual Property Rights (the TRIPS Agreement) has made acceptance of basic intellectual property rights a requirement for participation in the WTO system. This might be the case, for example, for the ILO Declaration on Fundamental Principles and Rights at Work of 1998. Other issues which might be regarded as an essential part of a multilateral investment framework, and for which multilateral agreements already exist which could be used or adapted for the purpose, include

combating bribery and cooperation in tax enforcement.[7] This model might also be an appropriate way to deal with the difficult problem of tax benefits and incentives, by associating a code on unfair tax competition, along the lines of the codes now being applied within the EU and by the OECD. Association of such agreements within a single framework would help to create public confidence that the benefits extended to investors by globalization would be complemented by a strengthened framework of international cooperation to prevent abuse of the freedoms of the global market.

Both agreements and non-binding standards could also be associated on a basis of reciprocal conditionality, which would provide flexibility. Thus, States could choose to extend investment protection benefits only to investors from States participating in specified agreements. Such conditionality could also be applied to enterprises through an appropriate denial of benefits clause. This would permit a State to deny the benefits of investment protection to enterprises breaching specified or related standards. Thus, for example, a host State could rule out bids for licences or concessions, or cancel them, if the enterprise concerned were found to be in breach of relevant standards. Thus, a firm which breached prior informed consent procedures, or provisions of the WHO Infant Formula Code, could be denied the right to bid for public contracts.

Finally, relevant agreements and standards could be associated within a multilateral framework for investment on an opt-in basis. States and enterprises could be encouraged to sign up to a range of agreements and codes as appropriate to their activities and circumstances. This would help to provide greater visibility for positive regulatory standards, as well as helping to authenticate both those standards and their monitoring and compliance mechanisms.

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[7] The 1988 Convention on Mutual Administrative Assistance in Tax Matters agreed in the Council of Europe and the OECD provides an existing framework for cooperation which goes beyond the minimal provisions of bilateral tax treaties. It has now been supplemented by the OECD Model Agreement on Exchange of Information in Tax Matters, adopted as part of the drive against harmful tax practices.

5. Conclusions

In the increasingly competitive world economy created by globalization, it is tempting for individual States and enterprises to take a short-term view, and to prioritize immediate advantages or returns. This makes it all the more important to strengthen multilateral arrangements, and to find ways to harness private initiatives, while ensuring that they strengthen public capacity and operate in harmony with democratically agreed public policies.

The various more or less voluntary social responsibility initiatives outlined above offer some advantages for economic development, but also raise some problems. Perhaps the main advantage is flexibility, since they can be adapted to the circumstances of particular firms and industries, and different host and home countries. Rather than lay down a rigid legal straitjacket, they can establish standards which are either minimum requirements or higher aspirational targets, and combine inducements with sanctions to encourage compliance. Their transnational operation can help to ensure that economic globalization helps to spread best practices of social responsibility in business, rather than ruthless competition to maximize profits and disregard externalized social and environmental costs.

The dangers of primarily voluntarist transnational initiatives of this type are perhaps that their uneven impact may reinforce competitive disadvantages, and they may be viewed either as an imposition of foreign standards or as a mere fig-leaf. Resolving these problems calls for responsible and cooperative relationships between States, enterprises, and the wide range of civil society organizations.

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Corporate social responsibility and FDI

Daniel Graymore

1. Introduction

This paper focuses on the issue of corporate social responsibility (CSR) in relation to foreign direct investment (FDI), and asks whether CSR "expectations" should be addressed within an international investment agreement (IIA) at the World Trade Organization (WTO).

CSR[1] has been defined as containing three "substantive" elements; economic development, sustainability and human rights. It is possible to consider human rights and the environmental protection part of sustainability to be about curbing abuses of social and environmental standards. Economic development, and the rest of sustainability (medium- to long-term patterns of development that are environmentally and socially sustainable) are about promoting positive actions conducive to development.

Christian Aid believes that TNCs can play a positive role in development through, for example, technology and knowledge transfer, job creation, higher wages and labour standards, and through the introduction of newer, cleaner technologies to protect the environment. A vibrant private sector is a vital component to long-term development.

[1] For some CSR has become an inappropriate term when considering actions which society quite legitimately expects of corporations, whether foreign or domestic. In such situations it is considered more appropriate to talk of holding companies accountable to society for their impacts – hence corporate accountability. Where corporations may seek to go above and beyond society's minimum expectations, CSR is appropriate since a given company is acting particularly responsibly as against only fulfilling minimum expectations. I will continue to use CSR for the sake of consistency.

However, Christian Aid has become concerned that many of the successful policies that have been used in the past to capture the positive development benefits of FDI are becoming unavailable to host countries. Furthermore, as an organization working with poor and vulnerable communities in 60 countries worldwide Christian Aid is very aware of how TNCs can also harm lives and livelihoods by causing damage to the environment, operating to low labour standards and by direct, or complicit, abuse of human rights.

There are three key factors related to FDI and TNCs that contribute to this situation:

(a) Legal limitations on corporate accountability: despite national regulations, TNCs can be structured internationally in such a way as to make liability hard to identify, and redress nearly impossible to pursue. Furthermore, TNCs are not direct actors in international law making universally agreed human rights standards, for example, binding on States but not corporations.

(b) Power imbalances: TNCs are increasingly powerful actors in development. Where they represent a significant source of FDI, or where a State is in competition with other States to attract FDI, pressure can be brought to bear on social and environmental standards, driving them downwards, or at best, keeping low standards low, and weak enforcement weak. This also makes it hard to introduce or maintain host country measures designed to capture development gains from FDI.

(c) FDI liberalization: rigid investment agreements, including bilateral investment agreements (BITs) and the WTO's trade-related investment measures (TRIMS) agreement, are also making tried and tested host country measures such as performance requirements unavailable to developing countries. This also makes it hard to capture development gains from FDI.

2. Legal limitations

TNCs currently operate under a "legal fiction" whereby a parent company can limit its liabilities for the operations of subsidiaries and affiliates regardless of the degree of control exercised by the parent over the affiliate or subsidiary. This limited liability means that TNCs are able to manipulate jurisdictional rules and regulatory differences between States to avoid regulatory requirements. With the majority of the largest TNCs domiciled in OECD countries[2] this most commonly means that companies with headquarters in countries such as the United Kingdom or the United States can operate in developing countries to significantly lower standards than those expected of them at home, without bearing liability for the impact of those operations.

Where harm is caused by TNCs they should be held accountable for the outcomes, but this is very difficult. As one Australian judgement put it:

> "The law pays scant regard to the commercial reality that every holding company has the potential [to] and, more often than not, in fact, does, exercise complete control over the subsidiary".[3]

Another problem that gives rise to manipulation of jurisdictional rules to avoid liability is the fact that international law is still focused on State-to-State legal frameworks. Whilst States are subject to universally agreed, legitimate human rights and environmental standards, there are no mechanisms for making ethical standards and human rights binding for corporations.[4]

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[2] *World Investment Report 2000*, UNCTAD, New York and Geneva, 2000.

[3] Briggs v James Hardie & Co Pty Ltd (1989) 16 NSWLR 549, at 577, quoted in H. Ward, *Governing Multinationals: The Role of Foreign Direct Liability*, RIIA, London, 2001, p. 2.

[4] UNDP *Human Development Report 1999*, New York/Geneva, 1999, p. 100.

3. Power imbalances – A race to the bottom?

Over the past 20 years TNCs have become increasingly powerful, influential and important actors on the international stage. It is estimated that there are currently about 65,000 TNCs with over 850,000 affiliates abroad.[5] In the year 2000 FDI was a staggering $1.3 trillion.[6] The power that TNCs enjoy is derived from the potential benefits they bring to economies. Governments globally court TNCs, and TNCs lobby Governments for preferential terms and conditions.

The legal limitations described above, combined with the increasing power of TNCs, have created a serious imbalance of power between host States and investors. This has set the scene for a potential race to the bottom, as pressure is brought to bear on social and environmental standards.

Although investment decisions rest on a number of factors, including market access, the main considerations for many TNCs investing in developing countries remain relative labour costs and the location of exploitable natural resources.[7] Limited liability can create an incentive for companies to push for the lowest costs and standards. At the same time the World Bank, the International Monetary Fund and the international donor community have encouraged developing countries to liberalize investment regimes to attract FDI. Inevitably Governments have come under pressure to relax labour and environmental standards.[8] For example, it is fairly common to offer exemptions from national labour protection, including union recognition, in export processing zones (EPZs).[9]

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[5] *World Investment Report 2002*, UNCTAD, New York and Geneva, 2002.

[6] *World Investment Report 2001*, UNCTAD, New York and Geneva, 2001.

[7] *Trade and Development Report 2002*, UNCTAD, New York and Geneva, 2002.

[8] C. Oman, *Policy Competition for Foreign Direct Investment: A Study of Competition among Governments to Attract FDI*, OECD Development Centre, 1999.

[9] *The Relationship between the enjoyment of human rights, in particular labour and union rights, and the working methods and activities of*

There is a great deal of controversy about the race to the bottom. Whilst some argue that it is happening, and cite anecdotal case studies illustrating its occurrence, others argue that TNC investment actually drives up standards, employee conditions and wages. The evidence is inconclusive. At best the academic research suggests that the desire to attract FDI is keeping standards low or encouraging lax enforcement. The Organisation for Economic Co-operation and Development (OECD) reports that there is a continuing gap between recognition of core labour standards and their application. Despite claims that TNCs bring higher labour standards, an OECD study found no evidence of substantial progress overall in reducing non-compliance with respect to freedom of association and the right to collective bargaining.[10] Research by the Nautilus Institute asserts that a desire to be attractive to foreign investors in a highly competitive global economy has "kept a lid on local/national [environmental] standards or enforcement of standards". It goes on to point out that there are "pollution zones" of poorer people, both within and across countries, where firms perform worse and where regulation is less effective.[11]

Moving beyond the abuse of minimum standards, this same dynamic can hamper the development objectives of individual countries. FDI managed correctly can provide important financing for projects vital to the long-term development of a country. However, donors and investors have increasingly pressured developing countries to create more business-friendly environments for investment, including tax holidays, subsidized water and electricity, and 100 per cent

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transnational corporations, background document for the Commission on Human Rights, UN Doc. E/CN.4/Sub.2/1995/11 (July 1995).

[10] *International Trade and Core Labour Standards*, OECD Policy Brief, October 2000.

[11] L. Zarsky, *Havens, Halos and Spaghetti: Untangling the Evidence About the Relationship between Foreign Investment and the Environment*, Nautilus Institute for Security and Sustainable Development, presented at the Conference on FDI and the Environment: OECD Environment Directorate, The Hague, Netherlands, 28 – 29 January 1999.

profit repatriation. These policies have sometimes been successful in attracting TNC investment, but have reduced some of the potential developmental gains from FDI.

4. FDI liberalization

Increasingly rigid, international agreements on investment and trade are also serving to limit the autonomy of poor countries in enacting policy that meets their own individual and best interests. Some of the tried and tested tools that have been used in the past by States to manage their relationship with investing companies have become unavailable. Countries such as Taiwan Province of China and the Republic of Korea used host country measures to actively manage FDI so as to create forward and backward linkages between foreign and domestic companies and ensure technology transfer. But developing countries today are limited in the extent to which they can use these policies. For instance, the WTO's trade-related investment measures agreement (TRIMS) precludes performance requirements such as local content policies, whilst many other investment agreements (whether bilateral or regional) emphasize national treatments making it hard for countries to support the development of domestic capacity.

5. Voluntarism

In the absence of an effective international legal framework, with companies becoming more powerful and in the context of increasingly restrictive international agreements on investment, many countries and TNCs have pointed to voluntary CSR agreements such as the UN's global compact as a way of bringing social, environmental and developmental objectives back into decision-making.

Voluntary initiatives, such as codes of conduct, can be welcome in terms of the way in which they have led some companies to acknowledge their responsibilities. However, on

their own, self-regulatory mechanisms are insufficient responses to the problems that can be caused by TNCs. Most importantly:

- They are rarely monitored and lack consistency and enforceability. There are no penalties for non-compliance;
- They often lack transparency. For instance, it is difficult to find out which companies are members of the Global Compact;
- When linked to governments they often depend on political will. The OECD Guidelines for Multinational Enterprises rely on Government commitment to be applied;
- They lack a participative commitment to ensure that civil society groups – particularly poorly resourced community groups – have access to a system of redress.

Whilst some companies do respond positively to voluntary initiatives, these tend to be consumer-facing, high-profile brands that gain from a positive brand image. Even with these companies compliance is low. With the majority of companies interest is even lower and will remain so unless they are compelled to act. It is interesting to note that business leaders recognize this. For example, top executives at BP, writing in their own capacity, have stated, "There is a reasonable fear that multinational corporations will pursue profit regardless of other considerations, and duck their … ethical responsibilities".[11]

6. OECD Guidelines for multinational enterprises

The OECD Guidelines for Multinational Enterprises require a special mention, not least because they were intended as the CSR component of the original Multilateral Agreement on

[11] A. Mackenzie, and D. Rice, "Companies Can Show the Way to a More Ethical World", *The Guardian*, 15 January 2002.

Investment (MAI). The OECD Guidelines are promoted as the international response to the need for some framework of high standards within which companies should operate. Since all companies domiciled within OECD countries are covered by the guidelines they are not really voluntary. However, since in practice it appears to be up to a company whether or not they work to the standards, they might be described as voluntary.

The Guidelines cover a significant range of important issues, from human rights and environmental protection, through to development obligations and consumer protection. Some of the problems[12] with the Guidelines as currently formulated are:

- They fail to empower affected communities;
- They are non-binding;
- The enforcement mechanism, National Contact Points (NCPs), address allegations of non-compliance through consensual, non-adversarial means and by issuing unenforceable recommendations;
- Procedures for filing complaints are opaque and vary significantly from country to country – in one country non-governmental organizations (NGOs) have been required to produce power of attorney before submitting a case, and in another the NCP will not act unless NGO concerns are channelled through a trade union;
- NCPs are often staffed by inexperienced personnel who have the dual role of NCP and helping the private sector to attract investment and commercial opportunities.

The main concern with the OECD Guidelines is their basic lack of success. Since their launch in 1976 few cases have been brought, and with little in the way of meaningful outcomes.

[12] P. Feeney, *Making Companies Accountable*, mimeo, 2002.

7. CSR recommendations

In the light of the insufficiency of voluntary approaches, Christian Aid is calling for the establishment of international, legally binding regulation of TNCs to set minimum human rights and environmental standards. This would require an international agreement, which could be in the form of a convention that developed legally binding direct and indirect obligations on TNCs. It would primarily seek to support action at the national level by removing the downward pressure on standards and enabling developing country Governments to develop, implement and enforce higher standards.

With the indirect approach the obligation is on the State to enforce human rights and environmental standards, that is, indirectly applied to TNCs through the State. This would require a State to sign up to the convention. With the direct approach the obligations are applied directly to the company. National legislation and institutions would be the primary way of implementing these minimum standards. However, in the case of direct obligations, a company could be held to account even if the State within which it was operating had not signed up to the convention.

National legislation would recognize countries as both home and host States, and provide the facility to hold the activities of TNCs and their subsidiaries in host countries to account in home countries where appropriate. One way of addressing this would be to develop a "presumption of liability" between parent and affiliate. This would seek to establish the principle that a parent company is responsible for the actions of its subsidiary unless it can prove the contrary. In this way parent companies that export dirty technologies or that engage with repressive regimes can be held properly accountable under the laws of the country in which the decisions were made – usually the parent's home country. However, if it can be shown that the relevant decisions were made elsewhere, then liability, properly, should be with the decision makers and not the parent company.

Finally, if developing countries are going to be able to capture the developmental benefits of FDI, international investment agreements need to contain greater policy flexibility and autonomy so that host country measures that have been successful in the past can be used by developing countries.

8. Recent developments in corporate accountability

Policies of this sort may appear ambitious. However, important new initiatives are paving the way for greater corporate accountability. These include:

- The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, which makes it a crime to bribe foreign officials. Extraterritoriality is central to the convention.
- In the United Kingdom cases have been brought seeking to establish foreign direct liability (FDL) of corporations domiciled in the United Kingdom, but operating in third countries. The fact that the cases have been heard in the United Kingdom has set an important precedent. In the United States this type of action is being brought under the Alien Tort Claims Act.
- The Publish What You Pay Campaign is seeking an international agreement to require extractive industry corporations to disclose revenue payments to Governments. The United Kingdom Government is very supportive, as are a number of important TNCs.
- The CORE (Corporate Responsibility) campaign in the United Kingdom has a growing coalition of NGOs, trade unions and politicians calling for direct liability for directors of companies, for triple bottom line reporting (environmental, social and financial) and for a set of international standards to which companies would be expected to act. This campaign is likely to spread to other EU countries.

- A number of countries, including Australia, France and Brazil, have already introduced legislation requiring companies to report on social and environmental impacts.
- The European Parliament recently passed a resolution calling for corporate accountability measures, and the European Commission issued a white paper on CSR, which, though emphasizing voluntary approaches, has started a process that will report back in 2004 on whether stronger measures are required.
- The United Nations Subcommision for the Protection and Promotion of Human Rights has drawn up a draft set of human rights guidelines for business enterprises.

9. Regulation and the WTO

This paper started with the question whether CSR "expectations" should be addressed within an international investment agreement at the WTO. The simple answer here is "no".

Whether future investment agreements should refer to CSR "expectations" is another matter, but a future investment agreement in the WTO would not be an appropriate place to address the need for international corporate accountability standards. This is for a number of reasons. The experience of IIAs is one of liberalization, not regulation; domestic policy space to regulate TNCs has been reduced under agreements such as TRIMS. The *World Investment Report 1998* noted that of the 151 FDI policy changes that occurred worldwide during the period 1991–1997, 94 per cent contributed to creating more liberalised conditions for FDI.[13] Investment liberalization has created rights for corporations, not responsibilities.

[13] *World Investment Report 1998*, UNCTAD, New York and Geneva, 1998, p. 94.

Perhaps more significantly, the WTO has neither the mandate nor the competence to develop an international agreement on corporate accountability. The mandate of the WTO is trade liberalization, and its competencies lie in that area. The competencies required to develop an agreement at the international level to enforce CSR or corporate accountability would include, for example:

- Experience of the development of international human rights, and environmental, social and economic standards;
- Implementation, monitoring and enforcement compliance mechanisms, which would need to be sensitive to local situations; and
- International liability and redress systems.

Furthermore, it is vital that any corporate accountability mechanism be credible amongst a majority of civil society groups, businesses, trade unions and governments. The only body that presents itself as having those competencies is the United Nations.

10. Conclusion

This paper started by defining CSR as having three primary elements; economic development, sustainability and human rights. In seeking to address these three areas I have argued that regulatory responses are required in order to curb environmental and social abuses, whilst greater policy autonomy is required if developing countries are going to gain from FDI in terms of long-term development.

This does not preclude voluntary initiatives that go above and beyond society's minimum expectations. However, in the absence of effective regulation such voluntary CSR mechanisms are insufficient to ensure that TNCs play a positive

role in development. This paper also argues that regulation must be developed at the international level if developing country Governments are going to be empowered to implement and enforce national-level regulation.

However, the call for international responses to the need for higher standards should not be met by initiatives at the WTO. The WTO is neither mandated to take on this work, nor does it have the necessary competencies. The UN is the only appropriate body that could legitimately forward work on the development of an international framework on corporate accountability. Furthermore, if developing countries are to capture the long-term development benefits of FDI, IIAs need to contain greater policy flexibility.

Of course, this does not mean that future, flexible investment agreements should not contain corporate accountability dimensions. But these agreements would be expected to reference international agreements on corporate accountability, housed within the United Nations.

PART IV

The right to regulate

FDI and the right to regulate: Lessons from trade law

Joel P. Trachtman

1. The problem of domestic regulation versus international trade and international investment

International trade law has more experience with domestic regulation, as such, than does international investment law. So it may be worthwhile to consider the disciplines on domestic regulation that have been implemented in international trade law, principally within the WTO, in connection with an evaluation of a multilateral regime for investment.

Of course, there are both similarities and differences between international trade and international investment in their relation with domestic regulation, as well as in their relation with other international regulation. It is worthwhile briefly to explore these similarities and differences before we explore some of the disciplines developed in the trade context and their applicability to the investment context.

(a) Similarities: Protectionism and discrimination

There is the potential for protectionist use of domestic regulation in connection with both trade and investment. Thus, Governments may use domestic regulation in the trade context to defect from their tariff-reduction or other trade liberalization commitments. Here, they are restricting the entry of foreign goods and services (note that where they restrict the entry of services in "mode 3 – commercial presence" – there is a cross-over to investment). Protectionism may occur either "at the border" with respect to goods, or at the "pre-establishment" stage with respect to investment, on the one hand, or may occur internally or post-establishment, on the other hand.

Protectionism may take the form of discrimination. Here, so long as the motivation of the host State is protectionism (as opposed to other forms of economic nationalism), the concerns would appear to be similar, and indeed in NAFTA Chapter 11 cases, tribunals have referred to GATT discrimination jurisprudence (e.g. S.D. Myers,[1] Pope & Talbot[2]) in connection with de facto discrimination. Embedded in both analyses is the question of to what extent the regulatory categories of the host State or importing State will be respected as valid bases for different treatment.

On the other hand, market access in the trade sense seems to correspond most closely to the right of establishment in foreign investment. While rules against discrimination may be structured to apply *pre*-establishment (in addition to *post*-establishment), this is less common in foreign investment agreements.

Finally, trade law and foreign investment law share a concern regarding performance requirements.

(b) Differences

Since the 1979 Tokyo Round, trade has been concerned with product standards, and the ways in which these can hinder trade, either intentionally or unintentionally. Thus, the Agreement on Technical Barriers to Trade (TBT) and the Agreement on the Application of Sanitary and Phytosanitary

[1] S. D. Myers v. Government of Canada, Partial Award (13 November, 2000) (hereinafter Myers Award). In the recent Asbestos and Korean Beef cases, discussed below, the WTO Appellate Body made competitive relationship the critical factor in determining likeness.

[2] Pope & Talbot, Inc. v. Government of Canada, Award on the Merits of Phase 2, 46-63 (10 April, 2001) (hereinafter Pope Merits Award), citing Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos – Containing Products*, WT/DS135/AB/R, adopted 5 April 2001; Appellate Body Report, *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, adopted 25 September 1997; Panel Report, *United States – Measures Affecting Alcoholic and Malt Beverages*, adopted 19 June 1992, BISD 39S/206.

Measures (SPS) address concerns about regulatory protectionism or unnecessary regulatory barriers. This type of concern has not been addressed in specific terms in foreign investment law, but may conceivably be sought to be addressed through provisions on minimum standards of treatment or discrimination. It may be useful to compare the Methanex[3] case in NAFTA with the Asbestos[4] case in the WTO in these terms.

In connection with GATT law of national treatment, there has developed a (disputed) distinction between regulation of products and regulation of production processes. Without going into the jurisprudential details, the end result of this distinction is that importing States are permitted to regulate imported products, but are not permitted to regulate the production process in connection with such products. This is equivalent in many respects to a rule of territoriality: the State on whose territory the productive facility – the investment – is located is entitled to regulate that facility. Thus, the trade law system has generally not developed systems by which to supervise national rules relating to production processes.

The political economy of investment seems quite different from that of trade. That is, there seems to be less political pressure in host countries to construct barriers to investment than there is to construct barriers to imports of goods and services. In fact, many countries seem to have policies oriented towards the promotion of foreign investment, constituting a change since the 1960s and 1970s, in part resulting from the debt crisis of the 1980s. Thus, there may be fewer incentives to defect from liberalization commitments in the investment field than in the trade field, and hence less reason for international legal protection.

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[3] See Notice of Arbitration under the Arbitration Rules of the United Nations Commission on International Trade Law and the North American Free Trade Agreement, between Methanex Corporation and the United States of America (3 December, 1999).

[4] WTO Appellate Body Report: European Communities – Measures Affecting Asbestos and Asbestos-Containing Products, WT/DS135/AB/R, ¶ 100, adopted 5 April 2001 (Asbestos Appellate Body Report).

Other kinds of "economic nationalism" may apply in the foreign investment area, including concern regarding local control of the economy. There may be related concerns that foreign investors would do several things differently from local investors. First, they may import more raw materials or intermediate goods – certainly, intra-enterprise trade is a very significant component of global trade, and therefore one would expect some relationship between trade protectionism and concerns regarding foreign investment.

Second, there may be concerns that foreign investors would act with less regard for the local environment, labour force and other "social" values than would local investors. This concern may give rise to suggestions of special extra-regulatory corporate social responsibility. This assertion of responsibility would presumably discriminate between local investors and foreign investors. It is predicated, in part, on either (a) an assumption that the host State regulatory capacity is otherwise incapable of managing the negative externalities caused by the investment; or (b) a more paternalistic position that the local regulatory motivations are otherwise inappropriate. Third, foreign investors are likely to repatriate profits and, at some point, capital. Fourth, foreign investors may seek diplomatic protection, and may seek better arrangements than those available to local investors. Finally, there may be special concerns, such as national security concerns, regarding foreign ownership of certain types of properties or industries.

International trade regulation has not addressed the core foreign investment issue of expropriation, leaving this as a distinctive concern of foreign investment agreements. It is possible that expropriation could be addressed in connection with commercial presence in trade in services.

A final difference is that host States may seek to regulate in such a way as to provide special incentives for inbound investment. While there is little evidence that businesses respond to "regulatory laxity" as a basis for their investment decisions, it may well be that Governments act on the basis of an

assumption that they do. Rules such as Article 1114 of NAFTA may actually contain, if not an obligation to regulate, an exhortation not to diminish regulation for the purpose of attracting foreign investment.

2. Disciplines on domestic regulation in international trade law and their potential application in international investment

The foregoing brief analysis suggests caution regarding any efforts to transplant constraints on domestic regulation from the field of international trade law to the field of foreign investment law. However, to the extent that some of the motivations are similar, and even where motivations are not similar, it is a worthwhile exercise to examine some of the complex structures that have been developed to discipline domestic regulation in international trade law, in order to inform discussions of domestic regulation in relation to international investment law.

(a) Positive integration and negative integration

This summary focuses largely on certain negative integration powers (the power of the WTO to strike down domestic regulations) available in WTO dispute settlement, to be exercised through the application of general standards.

The WTO has much more limited powers of positive integration (the power of the WTO to "re-regulate" at a multilateral level) available to be exercised through the legislation of specific rules. Yet the law making in the areas covered by the SPS and TBT agreements is quite unique. Positive integration has two main potential components: harmonization (international legislation or standardization) and recognition. While these agreements contain no firm requirements of harmonization, they provide some incentives for States to formulate and conform to international standards developed in other fora. Foreign investment agreements do not seem to contain capacity for positive integration, but it may be that positive integration accomplished in other fora will promote foreign investment.

The right to regulate does not have to be exercised only at the domestic level. While the State will continue to be the main source of regulation, there will be circumstances where States will find it useful to enter into agreements for recognition or harmonization, or to establish organizations to promote efforts for recognition or harmonization. Articles VI:4 and VII:5 of GATS may be understood as a facility for such efforts.

Finally, the negative integration rules that this summary addresses are often applied by courts or tribunals, pursuant to broad grants of authority relating to national treatment, most-favoured-nation treatment (MFN), necessity, proportionality, and so forth. Many, including the judges in these courts, are uncomfortable with these broad grants of authority to bodies that are not directly elected or accountable in a direct political process. However, we must understand the judge in these contexts as an agent of the legislature, and as the "default option" for dealing with circumstances covered by these grants.

There is an obvious alternative: treaty negotiators or other political branches may address these issues themselves, especially in more specific rules of harmonization or recognition. Theory suggests that when these issues arise more frequently, require less customized responses, and entail lesser political costs of specification, legislative bodies will engage in greater efforts to address these issues with more specific rules. In fact, we may understand the operations of courts in these contexts dynamically, as a kind of "pathfinder" that may identify and address some of the issues, providing information to legislators that will allow them to act more precisely. Furthermore, as courts speak to more issues, in a system where precedent is either binding or otherwise respected, the judicial process itself may elaborate more specific rules over time. This perspective may suggest that the core problem of NAFTA Chapter 11 is that it is a young system, and we have not yet had sufficient experience to develop confidence that it will permit sufficient "right to regulate". In this sense, criticism of Chapter 11, and rectification through amicus briefs, lobbying and governmental action, may be understood as part of a process that begins with a degree of (hopefully) rational ignorance, or uncertainty, about how these rules will be articulated over time.

(b) Non-discrimination

Non-discrimination is extraordinarily complex when sought to be applied in the de facto discrimination context in connection with regulatory discrimination. There are at least three extremely difficult initial issues.

First, are the products, services, service providers, investors, investments or circumstances, as the case may be, comparable enough – in the trade context, "like" – in order to invoke a prohibition against discrimination? The Appellate Body's jurisprudence in this connection under Article III of GATT has moved away from the recognition of national regulatory categories as a plausible basis for determining "likeness", towards reference to competitive relationship as the central inquiry to determine likeness.[5]

Recognizing that this approach might otherwise result in the inappropriate invalidation (subject to exception under Article XX in the GATT context) of much domestic regulation, the Appellate Body in the Asbestos case underscored a second prong of the national treatment test: whether the treatment accorded the like products is "less favourable".

Third, and an issue we will not address in detail here, is the question of the scope of regulation. In the goods field, this arises as a question of the product–process distinction. Under the GATT Tuna-Dolphin jurisprudence,[6] the panels took the view that Article III applies only to the regulation of goods, as such, as opposed to the production process by which they were produced. If domestic measures were not "subject to" Article III (under the note Ad Article III), they were subject to Article XI, which amounted to fairly strict scrutiny, and could only be GATT-legal if they were exempted under Article XX.

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[5] *See* Asbestos Appellate Body Report, note 4 above.

[6] Panel Report, *United States – Restrictions on Imports of Tuna* ("*United States – Tuna (EEC*"), 16 June 1994, unadopted, DS29/R; Panel Report, *United States – Restrictions on Imports of Tuna* ("*United States – Tuna (Mexico)*"), 3 September 1991, unadopted, BISD 39S/155.

There is so much we could say about non-discrimination in the WTO context, including about MFN. I want to make only one point in this brief treatment. Rules of non-discrimination cannot be applied to de facto discrimination without judging, and may entail the kinds of balancing or necessity tests that are often criticized in other contexts. This is not intended as a critique of rules prohibiting discrimination. Rather, it is intended as a critique of arguments that it is illegitimate or otherwise inappropriate for courts sometimes to engage in necessity, proportionality or balancing analyses.

If applied without judgement, simply examining whether any two competing products are treated differently, anti-discrimination rules would inappropriately invalidate much valid regulation.

(c) Necessity/proportionality/least trade restrictive (investment-impairing) alternative/balancing tests

Necessity, proportionality or balancing tests may operate as swords or shields. In the GATT context, under Article XX, they operate as a shield that is only needed to the extent that another provision of GATT, such as Article I, III or XI, is violated. Under the TBT Agreement and SPS Agreement (and to a far lesser extent in the GATS), various formulations of necessity tests operate as a sword: they are affirmative obligations, rather than defences to other claims. (In fact, one of the defects of the TBT Agreement seems to be that its prohibition of discrimination has no exception for measures that are appropriately justified by legitimate regulatory goals.) While investment agreements may not need additional swords, it may be useful to evaluate the utility of these types of tests as additional shields.

Since its inception, GATT has recognized that legitimate government policies may justify measures contrary to basic GATT market access rules. Traditionally in GATT, the exceptional provisions of Article XX(b) and (d) are available to justify measures – otherwise incompatible with other GATT provisions – if they are "necessary" to achieve specified regulatory goals. This has been interpreted to require that the country invoking these exceptions

demonstrate that no other WTO-compatible or less restrictive alternative was reasonably available to pursue the desired policy goal. The "necessity" qualifications contained in Articles XX(b) and (d) of GATT have been interpreted to require the national measure to be the least trade restrictive alternative reasonably available.

WTO jurisprudence has changed the traditional GATT reading of Article XX, including the parameters of the so-called "necessity test". First, in Gasoline, the Appellate Body determined that compliance with Article XX is now to be demonstrated in a two-prong test: first, whether the challenged measure is covered by one of the sub-paragraphs of Article XX; and, second, whether or not the measure is "applied" in a manner that constitutes arbitrary or unjustifiable discrimination or a disguised restriction on trade.[7] While Members have a right to invoke the exceptions, the exceptions should not be applied so as unjustifiably to frustrate the legal obligations owed to other Member States under the GATT. This recognition of a balance between rights and obligations is inconsistent with arguments for special deference to domestic sovereignty or regulatory capacity.

The Article XX necessity test was addressed in Korea – Beef,[8] where the Republic of Korea attempted to justify its dual retail system for beef by arguing the need for compliance with a domestic regulation against fraud. The Appellate Body interpreted the necessity test of Article XX(d) to imply a requirement for balancing among at least three variables:

> "In sum, determination of whether a measure, which is not 'indispensable', may nevertheless be 'necessary' within the contemplation of Article XX(d), involves in every case a process of weighing and balancing a series of factors which prominently include the contribution made by the compliance

[7] Appellate Body Report, *United States – Standards for Reformulated and Conventional Gasoline* ("*United States – Gasoline*"), WT/DS2/AB/R, adopted 20 May 1996.

[8] Appellate Body Report, Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef ("Korea – Various Measures on Beef"), WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001.

> measure to the enforcement of the law or regulation at issue, the importance of the common interests or values protected by that law or regulation, and the accompanying impact of the law or regulation on imports or exports".

After reiterating that WTO Members have the right to determine for themselves the level of enforcement of their domestic laws (a concept close to the "appropriate level of protection" referred to in the SPS Agreement), the Appellate Body called for an authentic balancing and weighing of (at least) these variables: "The more vital or important those common interests or values are, the easier it would be to accept as 'necessary' a measure designed as an enforcement instrument"; "The greater the contribution [to the realization of the end pursued], the more easily a measure might be considered to be "necessary"; or "A measure with a relatively slight impact upon imported products might more easily be considered as 'necessary' than a measure with intense or broader restrictive effects".

It is not clear how these variables affect each other, nor is it clear how their balancing would affect the final determination that a measure qualifies under Article XX and how this new test relates to the traditional "least trade restrictive alternative reasonably available" test. Yet in Asbestos, the Appellate Body tried to reconcile its new balancing test with the traditional least trade restrictive alternative test. For the Appellate Body, the balancing referred to in Korea – Beef is part of the determination of whether a WTO-compatible or less trade restrictive alternative exists to obtain the end pursued (as called for by the traditional necessity test of Article XX(b)).

It is important at this stage to note the similarity between the wording of the necessity tests under Article XX, that of Article 2.2 of the TBT Agreement and that of Article 5.6 of the SPS Agreement and its footnote, although of course, Article XX operates as a defence.

How do necessity, proportionality or balancing tests apply to the foreign investment context? In the foreign investment context, we have not yet seen constraints on States that go beyond non-discrimination and minimum standards of treatment. And there may

be no need to establish such constraints. However, it may be worthwhile to examine whether, as noted at the beginning of this section, these types of tests may be useful as additional protection for domestic regulation in the context of anti-discrimination, minimum standard of treatment or anti-expropriation rules. For example, the S.D. Myers partial award dated 13 November 2000, in the context of its evaluation of Canada's compliance with Article 1102's requirement of national treatment, evaluated whether there were means available to Canada to achieve its legitimate goals of fostering the domestic waste treatment capacity that would be less damaging to S.D. Myers' investment.[9] We might refer to this not as a "least trade restrictive alternative test," but a "less investment-impairing alternative test". As such, it helps to evaluate whether there may be a hidden protectionist motive, or whether the domestic regulatory goal is being achieved at disproportionate cost to foreign investment.

(d) Recognition and harmonization

In the Uruguay Round, in the area of sanitary and phytosanitary measures, and in the area of technical regulations, certain quasi-legislative authority was referred to certain other functional organizations. Let us focus on the SPS Agreement structure. (The TBT Agreement structure was recently interpreted in the Sardines case).[10] The definition of "international standards" contained in Annex A to the SPS Agreement appoints the Codex Alimentarius Commission (Codex), the International Office of Epizootics (OIE) and the International Plant Protection Convention (IPPC) as "quasi-legislators" of these standards in relevant areas. What do we mean by "quasi-legislators"?

First, the standards developed by the Codex, OIE and IPPC for human, animal and plant health, respectively, are, under the terms of their own constitutive documents, non-binding. However, Article 3.1 of the SPS Agreement provides that "Members shall base their sanitary or phytosanitary measures on international standards,

[9] Myers Award, note 1, at 255 above.

[10] Report of the Appellate Body: European Communities – Trade Description of Sardines, WT/DS231/AB/R, adopted 23 October 2002.

guidelines or recommendations, where they exist, except as otherwise provided for in this Agreement, and in particular in paragraph 3". Moreover, Article 3.2 states that SPS measures of WTO Members that are in conformity with international standards, guidelines or recommendations shall be "presumed to be consistent with the relevant provisions of this Agreement". The Appellate Body found that while Article 3.2 was a safe harbour, it did not establish the converse presumption: the Panel erred in presuming that measures that did not conform to international standards were inconsistent with the SPS Agreement.[11]

This is a refined system of applied subsidiarity, subtly allowing national autonomy subject to certain constraints. Prior to the advent of the SPS Agreement, Codex standards had no particular binding force unless accepted for application by national legislation. While as noted at the beginning of this summary, there seems to be less concern regarding regulatory protectionism in the investment field than in the trade field, further research should be done to examine whether the extension of these types of arrangements to the investment field would be useful. In addition to this normative research, it would be useful to examine the extent to which the SPS Agreement and TBT Agreement already have the cross-sectoral external effect of preventing substantial categories of potential regulatory protectionism in the investment sphere.

GATT contains no explicit requirements of recognition, although there may be circumstances where the "least trade restrictive alternative" pursuant to an Article XX necessity test would require recognition of a home country regulatory measure. Article 4.1 of the SPS Agreement requires recognition of other States' regulations: "Members shall accept the sanitary or phytosanitary measures of other Members as equivalent, even if these measures differ from their own or from those used by other Members trading in the same product, if the exporting Member objectively demonstrates to the importing Member that its measures achieve the importing Member's

[11] Report of the Appellate Body, *EC Measures Concerning Meat and Meat Products (Hormones)* ("*EC – Hormones*"), WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998.

appropriate level of sanitary or phytosanitary protection". This requirement of the SPS Agreement is stronger than the more hortatory obligation of Article 2.7 of the TBT Agreement, which simply requires Members to give positive consideration to accepting foreign regulation as equivalent, if the foreign regulation fulfils the importing State's objectives. Again, it would be useful to examine the extent to which the concerns regarding regulatory protection in the investment context are sufficiently addressed by these disciplines.

3. A procedural digression: private rights in investment agreements compared with private rights in WTO law

Perhaps one of the reasons why there seems to be greater concern in the investment context regarding international judicial scrutiny of domestic regulation than there is in the trade context is that the investment context includes private rights of action. NAFTA Chapter 11 and many BITs provide private persons with substantial rights to bring mixed arbitration against Governments. While some have argued that the WTO legal system should provide private persons with greater rights to bring lawsuits against Governments for violation of WTO law, often by comparison with the use of the doctrine of direct effect in European Community law, there may be good reasons not to provide these rights to private persons in the multilateral context.[12]

So why do we provide greater rights to bring cases to private persons in the investment context? The explanation may lie in history, and in a greater sensitivity to the more traditional (and less flexible) ownership rights implicated in private investment, compared with the "rights" to trade implicated in trade law. And we may be less concerned about these private rights in the investment context, to the extent that we can maintain a fairly clear, discrete and limited set of

[12] *See* Philip Moremen and Joel P. Trachtman, *Whose Right is it Anyway? Private Parties in EC – United States Dispute Settlement at the WTO,* forthcoming in *Harvard International Law Journal* (2003).

causes of action. However, to the extent that the scope of foreign investment claims is widened beyond our experience and expectations, there may be sound reasons to reduce the scope of private rights of action. Thus, it may be worthwhile to consider different classes of claims relating to interference with foreign investment – some that could be brought by private persons, and some that could only be brought by Governments.

Under circumstances of government control, there would be greater flexibility, greater opportunity for mutual deference, and greater governmental control over the types of cases brought and the types of arguments made. This would allow the right to regulate jurisprudence to develop in a more controlled way. In the European Community context, it has been suggested that direct effect was useful precisely because it avoided diplomatic flexibility that might have resulted in a reduced commitment to integration. Obviously, much depends on the goals of the particular project.

4. Conclusions and suggestions for further research

There appears to be less need to exercise international supervision over domestic regulation in the investment field than in the trade field. And in some areas, disciplines intended to prevent regulatory protectionism in trade may help prevent regulatory protectionism in investment. The right of establishment is most comparable to the liberalization commitments found in trade law, and where States make valuable commitments in respect of rights of establishment, international supervision may be useful in order to protect these commitments from defection.

It is worth recognizing that it is not easy to apply rules prohibiting de facto discrimination. However, courts in many jurisdictions have done this over time, and a legal realist would say that despite what they say about their analysis, they often follow a "smell test". Thus, much depends on the quality of the tribunal. Determining "likeness" or determining "less favourable treatment" will inevitably involve some determination to respect or not to respect the national regulatory categories. These determinations may be

supplemented by a "least investment-impairing alternative" test, or such a test may serve as a defence after a finding of violation.

The areas of minimum standards of treatment and of creeping expropriation, or regulatory takings, also require judging, and also have been addressed by courts in many jurisdictions over time. These issues, like the discrimination issue, may be assisted by a "least investment-impairing alternative" test. However, given the change in attitudes towards government intervention in the economy, and towards foreign investment, since the debt crisis of the 1980s, these issues may not be terribly serious dangers.

We may imagine a more elaborate balancing test extending the Korea–Beef/Asbestos line to the foreign investment context. Such a test could consider the regulatory goal, the contribution of the measure to that goal and the degree of impairment of foreign investment.

It may be useful to evaluate the potential application of a requirement for a scientific basis, or a risk assessment, in connection with domestic regulation applicable to foreign investment. It may also be useful to evaluate references to international standards or requirements of recognition, in connection with foreign investment regulation. This may extend beyond product and service standards, to standards regarding construction, safety and environmental protection relating to particular foreign investment projects. The TBT Agreement and SPS Agreement structures providing incentives to use international standards might be useful in the foreign investment context. Recognition could be useful, for example, in the context of bank regulation, as effected in the European Community's Second Banking Directive. There, of course, it was combined with essential harmonization.

It is clear that more precise definitions of expropriation or creeping expropriations are needed, but it is not clear that this should come through treaty revision or through elaboration by adjudication over time.

Finally, it would be instructive to consider how some of these issues have been addressed in the European Community, as it has moved towards liberalization of the four factors: goods, services, labour and capital, again, not for purposes of mere emulation, but for purposes of comparative assessment of tools.

Right to regulate and safeguards

M. Sornarajah

The creation of treaty obligations necessarily involves the surrender of sovereignty. States limit their sovereignty in order to obtain some benefit through such limitations. The safeguards provided under the GATT regime for international trade are well known. They are continued under the WTO regime. The right to regulate and the safeguards that are attached to investment treaties are different. Investment is more intrusive than trade in goods. The granting of rights to foreign investment is necessarily more erosive of the sovereignty of the host State than are rights granted in connection with international trade. The right to regulate investments is an aspect of the sovereignty of the State. Foreign investment is an activity that takes place within the borders of a State. The right to regulate such activity is inherent in the territorial sovereignty of the State.

But any matter that falls within such sovereignty can be lifted out of it through rules of international law formed through customary practice or obligations that the State voluntarily assumes through submission to rules of law created by treaty. That is a basic notion of international law. In the *Nationality Decrees Case*, the International Court held that a matter such as the conferment of nationality, an essentially domestic issue, could be subjected to international rules as a result of treaty obligations that had been undertaken. The whole area of international human rights law is based upon the premise that violation of human rights by Governments which essentially fall within the domestic jurisdiction of the State are of international concern because they are now subject to international law rules. Likewise, in the sphere of foreign investment, though the process of foreign investment is inherently domestic and territorial, the existence of treaty obligations lifts that process to the extent of its subjection to treaty obligation out of the sovereignty of the host State and subjects it to international rules. But a State would be wary of such a surrender of sovereignty. It

would want to safeguard the power of regulation which flows from its sovereignty and safeguard itself from abuse of those powers it has surrendered through the treaty obligations by the creation of safeguards and exceptions. It is necessary to analyse the pattern of investment agreements in order to assess the extent of the loss of sovereignty that is involved in the measures that are involved and the safeguards and exceptions that are created. Safeguards and exceptions apply to various major areas and it would be useful to consider them here under four categories — namely, definition of investments, treatment standards, protection of investments from expropriation and dispute settlement.

1. Definition of investments

Definitions of the types of investments that are protected are relevant when it comes to safeguards. States safeguard their interests by excluding types of investments which they find are deleterious to their interests. Thus, in South-East Asian investment treaty practice, it is common to grant protection only to investments "specifically approved in writing". This enables the host State to determine, having regard to its developmental and other interests, whether the investment is deserving of the treatment and protection standards in the treaty. Other treaties provide protection only to investments made "in accordance with the laws and regulations of the host State". Some treaties, particularly the Indonesian and Australian ones, go on to add a phrase and make it read "in accordance with the laws and regulations from time to time in existence". This formulation preserves sovereignty to a large extent, as the host State will have the ability to move out an investment from the scope of the treaty simply by legislation. It really emasculates the treaty and ensures that a State has complete power in determining whether or not to give protection to an investment. Unless there is resort to sectoral limitations or a qualification attached to the type of investment to be protected the treaty would list the nature of the property that is to be treated as investments.

2. Treatment standards

In the models of investment treaties dictated by economic liberalism, a central tenet becomes one of national treatment of foreign investors. Perfect national treatment applies to the pre-entry phase requiring that a State relinquish its sovereignty to control access of foreign investment to its territory. This ensures that there is no discrimination between the foreign investors and local entrepreneurs through the imposition of conditions on operations at time of entry. It would also mean that much of the screening laws of host developing states would have to be dismantled. Treaties containing pre-establishment entry are largely made by the United States, though Canadian and other treaties contain them. Regional treaties such as NAFTA and the ASEAN Framework Agreement on Investment also contain such obligations relating to national treatment at the pre-entry stage. But there are long list of sectors which are excluded from the operation of the standard in respect of such treaties. Safeguarding the interests of local entrepreneurs and local interests in these treaties is secured through the exemption of sectors. Other investment treaties usually include national treatment after entry. These treaties also prevent discriminatory treatment during the phases of investment after entry. Such discrimination is prevented only in a situation of “like circumstances”, a terminology from the area of trade, the interpretation of which has created interesting issues. It is unlikely that a foreign investor, who would come with massive economic power, will be in like circumstances to a local entrepreneur and, in that sense, the granting of national treatment will not be too much of a burden on a developing State.

In the case of most-favoured-nation (MFN) standard treatment, the general practice is to exclude from the scope of the MFN clause regional agreements which give partners in regional arrangements preferential treatment. Another danger with the MFN clause is that if there is a wider multilateral agreement such as the OECD's failed Multilateral Agreement on Investment, the MFN clause in that agreement may require the

extension of the advantageous rights contained in a bilateral treaty to all members of the multilateral treaty. This result may occur where a WTO instrument on investment comes about as well. Such a situation will bring about unintended consequences. A recently decided case, *Maffezini v Kingdom of Spain*, indicates the possibilities of the creative use of the MFN clause, and adequate precautions must be taken to ensure that the clause does not have unintended consequences.

3. Expropriation

The expropriation provision is the central feature of any investment treaty which aims at protection of the investment rather than liberalization of the investment flows. The formulation is couched in rather watertight terms contemplating not only direct and indirect taking but anything tantamount or equivalent to a taking and is followed by the requirement that full compensation be paid and that certain conditions be satisfied.

The great issue that has arisen particularly in the context of NAFTA litigation is whether regulatory taking to protect the environment or other factors such as health, morals or human rights would also be subject to the payment of compensation. NAFTA itself contains a weak provision seemingly exempting environmental taking, but the provision is generally considered to have only a hortatory effect. The broad provision on expropriation provided ammunition for the shooting down of the OECD's Multilateral Agreement on Investment.

Any provision on expropriation must now provide safeguards that would ensure the taking of environmental measures. The United States, the principal apostle of the watertight provision, seems to agree with this position in the manner it is arguing the *Methanex Case*. Its argument seems to proceed on the basis that where there is a general measure taken to protect the interests of the community through the legislative process, such a measure should not be regarded as an

expropriation. The general exception of measures taken to protect health, morals and the environment that operates in the sphere of international trade will have to be accommodated within the provision. This will take care of the concern of the different groups that have come out in opposition to the formulation of protection of the interests of multinational corporations without taking into account the concerns of the people of the world regarding poverty eradication, environmental protection and human rights protection.

4. Dispute resolution

The dispute resolution provision works in tandem with the expropriation provision. In the case of developing countries, most of the litigation has arisen from expropriation and not from violation of standards of treatment. The experience of the litigation under NAFTA between Canada and the United States, however, has largely concerned the treatment provisions. Since protection has been the main thrust of the dispute settlement provisions, there has been a definite movement towards the creation of an automatic and unilateral right of recourse to arbitration created in the foreign investor. This right has led to concerns that there is a considerable erosion of sovereignty involved as a result of such a provision. Again, the increasing NAFTA jurisprudence is instructive. It has become possible to question lower court decisions before arbitral tribunals on the ground that they constitute denials of justice. It has become possible to complain against administrative decisions made on environmental grounds before arbitral tribunals, which have always been inclined towards the protection of commercial interests. Again, the issue of safeguards against these trends being taken to extremes should be addressed. The old rule regarding exhaustion of local remedies at least provided a check in that it ensured that the dispute was first identified and a remedy attempted under local law by local courts. A return to such a position would safeguard sovereign interests.

The right of states to regulate and international investment law: A comment

Howard Mann

1. Rethinking the purpose of international investment agreements

In what has now become shorthand for a complex set of issues, the concept of "the right to regulate" is increasingly seen as a critical element for understanding the development of international investment law and policy. One driver for this is the role of civil society in raising questions about the apparently growing loss of national sovereignty in the face of broader and deeper trade and investment obligations being generated at the international level. A second but closely related driver is the growing body of cases where public welfare legislation has been challenged under trade and investment agreements.

This comment begins with a challenge that goes to the very heart of the current debate on international investment agreements (IIAs) and the right of the State to regulate. The challenge can be phrased as a simple question that many believe must now be answered before further development of IIAs: should the objective of investment agreements be to protect foreign investment, or to promote and protect sustainable foreign investment?

Civil society groups have, with few exceptions, mobilized forcefully against more negotiations on IIAs as a result of the experience under NAFTA's Chapter 11 on investment and the successful opposition to the negotiations of the Multilateral Agreement on Investment in the OECD. While this experience cannot be chronicled here, it suffices to say that both the substance and process associated with NAFTA have caused worry on issues such as the right to regulate and the transparency and suitability of the investor-state dispute

resolution process that determines whether investor rights have been breached by the exercise of the right to regulate. The underlying rationale for this opposition is that IIAs have become a charter of rights for foreign investors, with no concomitant responsibilities or liabilities, no direct legal links to promoting development objectives, and no protection for public welfare in the face of environmentally or socially destabilizing foreign investment.[1]

At the same time, a growing number of observers have demonstrated the need for FDI as an essential component of sustainable development strategies at the national and global levels. Quite literally, hundreds of billions of dollars in investments are needed today if poverty alleviation and development opportunities are to be moved forward in the developing world. This is most obviously so for the least developed countries. In addition, hundreds of billions of dollars in FDI is needed if unsustainable natural resource management and industrial practices in developed and developing countries are to be turned into sustainable ones. Only by maximizing global investment opportunities can these two fulfil this requirement. Given this perspective, new thinking on the role of IIAs as a tool for promoting sustainable development – the only conceptual framework that links these two global economic requirements – is needed.

This comment seeks to provide a basic understanding of how the notion of the right to regulate fits into a reconstruction of IIAs as investment agreements for sustainable development.

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[1] This view was solidified for many civil society groups with the release of the *Metalclad Corporation v. United Mexican States*, Award, International Center for Settlement of Investment Disputes (Additional Facility), Case No. ARB (AF)/97/1, 30 August 2000, where the Tribunal repeatedly refers to the investment promotion and protection purpose of NAFTA's Chapter 11 in an environmental case of significant importance.

2. A primary consequence of this change in thinking for addressing "the right to regulate"

A primary consequence of proposing such a change in thinking is that the context for the policy issues under consideration at the Expert Meeting, as described in the note by the UNCTAD secretariat, may benefit from some revisiting. For example, the structure and direction for the paper seem to address just one half of the relationship between foreign investors and their host States and communities: the impact of the domestic setting on the investment. It pays much less attention to the dimension that it is essential to address from a sustainable development perspective: the potential impact of foreign investments, especially FDI, on the local and host State economy, environment and social context.

It is important to state at the outset that the impact of foreign investments is not always, and is certainly not necessarily, negative. Quite the contrary, the very context of suggesting IIAs as agreements for sustainable development focuses the mind on achieving the positive results that are available from FDI. Doing so, however, requires a continuity in design that links all areas of investment promotion and management, rather than segregating specific issues in the context of the right to regulate.

For example, when discussing host country measures, the overview chapter focuses on promoting the local development relationships of FDI measures, but with no mention of local sustainable development relationships. This has several impacts. For example, it reduces or eliminates a potential focus on institutional development within the host State in areas such as environmental and labour management as part of the framework for attracting sustainable foreign investment, despite their critical relevance both to investors and to host States. It also reduces any discussion of the appropriate role of home countries, inside or outside IIAs, in supporting the development of these domestic legal regimes and institutions, or the potential to supplement host States' laws in these areas with minimum standards of conduct for foreign investors.

Using IIAs to supplement domestic legal regimes may, at first blush, sound overly aggressive and controlling of foreign investors. It should not. One must recognize that existing IIAs actually go well beyond supplementing one aspect of the legal and administrative infrastructure in host States: they create both choice of law and choice of forum rules that allow foreign investors to completely replace the host State laws on how they may be treated with international laws and remedies. There is no inherent reason why IIAs that already legally displace one aspect of host State laws cannot be used to supplement other areas when domestic regimes may not yet be sufficient to establish a longer-term, sustainable investment infrastructure.[2]

In this vein, the concept of corporate social responsibility (CSR) is often raised as a way to supplement host State requirements for foreign investors. CSR is raised in the section of the overview chapter on home State policies. One can imagine the development of specific rules or codes and so on relating to CSR, as was considered in the dying stages of the OECD's Multilateral Agreement on Investment negotiations. However, there are also opportunities, under a sustainable development concept for IIAs, to add additional links between home State policies and CSR. One such link is to require foreign investors to bring their home state laws "with them". This approach is very controversial and may not be the most appropriate approach, at least not in all cases. However, it is possible to use IIAs to ensure that general duties of care on foreign investors are legally applicable. In particular, rules in domestic courts that now limit or preclude headquarter companies from being forced to accept legal responsibility and liability for the acts of their foreign investments act as a negative incentive for CSR today. An IIA that has sustainable development as its core value rather than simply the promotion or protection of all foreign investments could include a

[2] Basic elements can be envisaged here: mandatory environmental assessments for projects above a defined level, environmental management system requirements, emergency preparedness, public disclosure, and other well-known and existing tools.

requirement for home States to undo any existing elements of rules, such as *forum non conveniens*, that continue to block judicial processes on liability.

The future development of IIAs should, it is submitted, consider the two directions of international law on foreign investment that are feeding the current civil society impression that international investment law is a system of corporate rights without responsibility or liability. While there is a growing right for a foreign investor to invest and repatriate all profits, there is only limited, and often no, liability placed on that same right-holder for how those profits are made. This perpetuates the sense of IIAs as part of a well-organized corporate agenda disconnected from any negative impacts created by the beneficiaries of the rights they contain. An international agreement that eliminates the *forum non conveniens* rule will ensure that the right to make a profit is coupled with the liability for how that profit is made.[3]

There is also a link here to the right to regulate. Many of the States that are the primary host State "targets" for investment agreements have both weak domestic legal regimes and enforcement regimes. While enforcement of laws can only take place within the enacting State, civil liability regimes work to buttress the sense of compulsion for meeting all relevant standards and duties of care, including environmental and human rights responsibilities. Thus, ensuring that the liability for decisions is co-located with the right to make profits from foreign investments will help domestic law enforcement in host States as well.

[3] Some difficult legal issues would certainly arise here. For example, should liability be attributable only for the decisions of the foreign investor itself, or also of the investment abroad? How can these be distinguished in practice, etc.? While there may be some difficult questions, these do not obviate the need to bring liability into the IIA framework.

3. Ensuring the right to regulate: Defining the right starting point

The right to regulate discussion in the current context has two distinct elements:

- The right to regulate foreign investment to promote domestic development priorities and linkages; and
- The right to regulate to protect the public welfare from possible negative impacts, both individual and cumulative, of foreign and domestic investments equally.

Given the awareness of how recent agreements have unfolded in civil society and Governments, both of these contexts are now critically important to the future of IIA negotiations.

The proper starting point for addressing the right to regulate in both these areas begins, it is submitted, with the simple proposition that the right to regulate is a basic attribute of sovereignty under international law. The right to regulate is not granted by trade and investment agreements. It is the restriction of the right to regulate that is at issue in this discussion, and a proper starting point would recognize that such restrictions ought to be applied as an exception to the general right to regulate, and only when it is demonstrably in the public interest to do so. A preamble that recognized this approach would reverse the current trends in trade law of seeing the right to regulate as an exception to be narrowly interpreted.

An additional factor in support of this starting point is the growing recognition, including in the WTO and the World Bank, that medium- and long-term benefits of trade and investment liberalization can only be achieved in the context of appropriate and effective domestic regulatory environments.[4]

[4] See, for example, H. Nordström and S.Vaughan. *Trade and Environment:* Special Studies 4. Geneva: World Trade Organization (1999);

Given this recognition, constraints that prevent the development of regulatory measures impacting on FDI, both pre-and post-establishment, can work to undermine what global economic institutions now recognize as essential to achieving both sustained and sustainable development. As a result, such constraints should presumably be limited, as already suggested, to when they are demonstrably in the public interest.[5]

An example of this approach in action would relate to performance requirements. While there is increasing evidence that performance requirements such as domestic content in manufacturing carry few benefits and create significant risks of scaring off investors, there remains some evidence that they can, in certain cases, have development benefits.[6] Thus, the issue can be framed as whether IIAs should ban all such measures or otherwise significantly discipline them, or whether the market provides a better vehicle for this while leaving States open to identify specific uses of performance requirements that may be beneficial to them. The approach suggested above would leave the market for inward investment as the primary vehicle for disciplining inappropriate performance requirements. It may be worth noting here that many regional trade agreements incorporate domestic content performance requirements in a backdoor manner through country of origin requirements that act as a pseudonym for local content requirements to be met before a product qualifies for beneficial tariff treatment within the regional market.

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and P. Fredriksson (ed.). *Trade, Global Policy, and the Environment*. Washington, DC: World Bank, 1999.

[5] There is considerable doubt, for example, about the capacity of most developing States to meet all the requirements of TRIPS, the TBT Agreement, the SPS Agreement and other trade law requirements.

[6] See, for example, the comments of Dr. Nagesh Kumar, "Use and Effectiveness of Performance Requirements: What Can be Learnt from the Experiences of Developed and Developing Countries?" at the UNCTAD Expert Meeting on the Development Dimension of FDI, Geneva 6–8 November 2002.

Other experts will focus on regulating for development purposes in the context of balancing foreign investor interests with domestic development policies and strategies. This includes issues such as pre-establishment national and most favoured nation treatment and performance requirements. In the sections that follow, the main area of focus will be on the regulation of investors in the public interest. This is primarily understood today as post-investment regulation, but we shall also suggest areas of pre-establishment regulation that are quite relevant.

4. Considerations relating to current trade and investment models on the right to regulate

The first point to make is that trade and investment are not the same thing. Trade may be an outcome of investments, and investments may be motivated by trade opportunities. In economic terms, there is clearly a close and increasingly complementary relationship between trade and investment decision-making. This close economic relationship, however, does not mean that the public welfare interest in trade and investment – and hence the need to establish rules as well as the character of those rules – will be the same.

Clearly, FDI is likely to have a far broader range of potential impacts on the host State and host community than the act of trading most products. Air and water emissions, water consumption in production processes, the types of technologies used and human resource relations in an industrial facility and community are among the many complex factors directly related to the establishment and operation of an industrial or natural-resource-based investment, whether foreign or domestic. For host States, these are fundamental matters directly and inextricably tied to ensuring that an appropriate and effective domestic regulatory regime is in place to ensure that the benefits of foreign and domestic investments are achieved. They are not issues that can be disconnected from an investment, and

therefore are not issues that ought to be disconnected from international investment regime building.

When the breadth of the investment relationship to the host State is considered, as opposed to just the host State relationship with the investor, it becomes clearer that a full reconsideration of the basic structure and purpose of existing IIAs is required in order to balance these two dimensions. This would properly anchor the rights of host States and communities in the international law relationship created by IIAs.

In the context of right to regulate issues, this suggests a strong need to recognize the inherent right to regulate as the starting point in an IIA. The preamble or a substantive paragraph can be used for this purpose. But such recognition cannot come with the type of simple caveat found in NAFTA's recognition of the right to regulate, "consistent with this Chapter".[7] This language acts not as a recognition of any inherent right, but as an expression of the primacy of the agreement and hence a limit to any right to regulate as the starting point in a legal analysis.[8]

The different impacts of trade compared with investments also means that one cannot assume that the rules of one field can simply be transferred to the other. To do so risks a serious misappropriation of rules and related institutions.[9] This is clear, for example, should anyone seek to transfer the analysis of "like products" in the WTO jurisprudence to a concept of "like circumstances" between domestic and foreign investment. The economic competition basis of the like products analysis

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[7] See Article 1114 of the North American Free Trade Agreement.

[8] Notably, this same language now appears in paragraph 6 of the 1991 Doha Ministerial Declaration of the WTO. It should be noted here that the environmental and human health exceptions generally applicable to NAFTA rules are not applicable to Chapter 11 on investment.

[9] See Konrad von Moltke and Howard Mann, "Misappropriation of Institutions: Some Lessons from the Environmental Dimension of the NAFTA Investor–State Dispute Settlement Process," *International Environmental Agreements*, vol. 1 no. 1 (January 2001), pp. 103–123.

yields a static assessment, while investments have a series of dynamic and ever developing relationships with host communities and States that vary from facility to facility and community to community. Local ecosystems, population concentrations, industrial concentrations, water tables, geographical impacts on air-sheds, the capacity to meet possible environmental liabilities, differing production technologies and other factors all defy any kind of simple test for assessing when investors are in like circumstances. National treatment and most-favoured-nation rules against discrimination based solely on the origin of the investor will have a place in investment agreements. However, only a full assessment of the two sides of the investor and host State relationship – the impact of State acts on the investor and the impacts of the investment in the host State and community – can establish a context for assessing an issue such as like circumstances.[10] In addition, a balance between prohibitions against arbitrary and abusive discrimination and circumstances where origin may be a legitimate factor to take into account will also have to be set out.[11]

A further general principle in setting out the right to regulate should be clarity. Trade and investment agreements have been strewn with general obligations that lack clarity and precision. National treatment, most-favoured-nation treatment, minimum international standards and expropriation rules all reflect a broad language approach to drafting in current agreements. But this approach is one that has now begun to distort the role of IIAs by making them available as swords to fend off new laws and regulations. The lack of precision and

[10] There is a growing debate about whether non-discrimination is now a principle of international law. In my view, this issue is not particularly relevant in the present context. What is clearly open to debate in the IIA context is the scope and application of any non-discrimination rules, just as they are continuously evolving in trade, human rights and other contexts.

[11] The capacity of foreign companies to address environmental emergencies and large-scale liabilities following a major accident may, for example, lead to additional emergency preparedness requirements and legitimate requirements for posting of bonds or other assurances.

clarity is being used by foreign investors to threaten arbitrations under IIAs as a response to proposed new rules, leading in many cases to a phenomenon of regulatory chill, the inability or fear of Governments to take measures due to the unknown but potentially very expensive consequences of vague IIA rules. In this context it is critical to note that investment agreements are now mainstream legal tools that one can anticipate being used as often as possible. The era of "gentlemen barristers" employing IIAs as tools of last resort is, simply put, dead. Drafters of IIAs must now respond to this change with the clarity and precision needed to give Governments security in their ability to act in the public interest.

The expropriation provisions in NAFTA's Chapter 11 provide a cogent example of this. Starting from various international and American legal positions, lawyers have now argued on several occasions that environmental protection measures with a significant economic impact on a business amount to a expropriation. While these arguments have not yet won in any case, it is equally true that the decisions in each case where it has been raised leave room for continued arguments on these lines to be made, creating ongoing uncertainty for government lawyers and regulators.[12]

5. The missing element: Investor–state remedies and the right to regulate

Closely related to the substance of the right to regulate is the process for adjudicating whether the right has been breached. This issue is absent from the overview chapter, but is fundamentally important for three reasons. First, in balancing the government right to regulate with private rights, IIAs have moved well outside private matters into matters of significant

[12] It is noteworthy that no compensation for clean air, water, hazardous waste management or similar legal measures has ever been paid in the United States, the purported source of the new and expanded international law interpretation on this issue.

public interest. In accordance with basic principles of justice in a democratic context, such issues require public hearing in impartially chosen and open tribunals.[13] The traditional investor–state process fails to meet these basic needs for adjudicating public welfare issues.

Second, the concept of sustainable development is increasingly understood as incorporating public rights of access to information and decision-making processes, and accountability of decision-making bodies. Again, the investor–state process fails on this count.

Third, the credibility of IIAs vis-à-vis the public and civil society has been savaged by the secrecy of the investor-state process. To this day, it is impossible for the best of researchers to know how many cases relating to regulatory measures have been initiated. Hence, the full impact of these agreements on environmental and other aspects of human welfare protection cannot be measured. In addition, the occasions on which threats of uses of IIAs have been successful cannot be determined. This secrecy discredits the entire process in the eyes of civil society groups, and quite legitimately so. Given the growing connection of IIA rights and their use in relation to regulatory measures, this issue cannot be disconnected from the substantive analysis of the right to regulate.

6. Conclusion

In conclusion, it is submitted that a reshaping of the purpose of investment agreements from protecting foreign investors to creating investment agreements for sustainable development will provide a proper basis for protecting the

[13] That investment cases now go beyond traditional private commercial matters to serious public policy and public welfare issues is recognized in *Methanex Corporation v. United States of America*, Decision of the Tribunal on Petitions From Third Persons to Intervene as "Amici Curiae", 15 January 2001.

inherent right of States to regulate in the public interest. This does not mean that no disciplines would be available to protect against discriminatory or abusive uses of government power. However, such a rethinking would reverse current trends towards seeing the right to regulate as something granted under trade and investment agreements to be exercised only in limited and defined circumstances. The new direction would see the right to regulate as something inherent in the sovereignty of States and thus to be limited only in specific and clear circumstances.

Such restrictions can serve legitimate public purposes, especially in relation to the good governance of all investors. A focus on IIAs as explicit instruments for sustainable development will ensure that identifying the public purpose for restrictions should be the first step in the process of enacting restrictions.

Domestic regulation and the GATS

Pierre Sauvé

1. Background considerations

Many service sectors are highly regulated with a view to achieving a range of policy objectives — for example, consumer protection, equitable and/or universal access to particular services, environmental protection, or, in the case of financial services, to protect a country's financial stability. Such regulation is an essential part of both good governance and a functioning market structure. Accordingly, the GATS recognises the right of Members to regulate, and to introduce new regulations on the supply of services to meet national policy objectives. Furthermore, given asymmetries existing with respect to the degree of development of services regulations in different countries, the General Agreement on Trade in Services (GATS) also recognizes the particular need of developing countries to exercise this right.

There are two main ways in which trade in services liberalization can intersect with domestic regulation. Firstly, in making regulations, Governments take into account a wide range of factors, of which one consideration may be the economic and trade/investment impact of such regulation. Information on potential effects may assist Governments in seeking the most efficient - but still effective – regulatory means of achieving their policy objectives. Indeed, there are positive effects in terms of overall democratic governance in the more efficient and transparent design, implementation and enforcement of regulations. Secondly, the process of liberalizing services markets can require new or different types of regulatory intervention, for example to ensure that the expected benefits of liberalization are realized (e.g. that liberalization results in a genuinely competitive market) or to ensure that important policy objectives continue to be achieved within the new market structure (e.g. universal service obligations).

This process of regulatory review and development involves consideration of a number of factors including, but not limited to the following:

What is the purpose of the regulation? What policy objective is it aimed at achieving? (e.g. consumer or environmental protection; prudential protection: ensuring competition or equitable and universal access to a service: reducing income and regional disparities).

Will the proposed regulation be effective in achieving that objective? If so, is it the most efficient way to achieve the objective? (e.g. factors to consider may include whether the regulation is reasonable, objective in its application and transparent; whether it is proportional to the objective being pursued; and whether it is linked to international standards).

How will the regulation be implemented? (e.g. are there transparent and impartial procedures for implementing the regulation? Can parties affected by the regulation provide input prior to its adoption? Do parties negatively affected by the regulation have any recourse to appeal?).

These questions are indicative only and are certainly not exhaustive. Consideration and weighing of these different factors, while essential for effective liberalization which serves national objectives, including development objectives, can be a challenging process, in particular for developing countries with limited administrative capacity. Many WTO Members require significant technical assistance in terms of regulatory capacity building, as well as training and assistance regarding the implementation of regulations.

2. GATS and the right to regulate

Threats to a country's sovereign right to regulate, or the alleged transfer of regulatory authority from national Governments to a supranational body such as the WTO, is a

central plank of the anti-GATS critique. Agreements to accept a framework of rules, whether bilateral, plurilateral or multilateral, by definition entail some curtailment of sovereignty, although the decision to enter into such an agreement is itself an exercise of sovereignty. Over 140 Governments have chosen through membership of the WTO to participate in a package of multilateral agreements because they recognize the overall net economic and social benefits that accrue from a rules-based trading system.

The principal concern linked to loss of sovereignty is the consequent loss of a nation's freedom to regulate its service sectors in the manner it deems appropriate. Many service sectors are highly regulated in order to protect consumers and the environment, and, in the financial services sector, to ensure a country's financial stability. Governments are understandably cautious when agreeing to subject themselves to common rules. Such regulatory precaution is reflected in the provisions of the GATS, which uphold the fundamental right of a Government to regulate in order to pursue national policy objectives. The Agreement's preamble recognizes inter alia "the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives".

The progressive liberalization, not deregulation, of services trade is the goal of the GATS and of periodic negotiating rounds. A common misunderstanding in the public policy debate over GATS is to use the terms "liberalization" and "deregulation" interchangeably, as if they were synonyms. They are not, and it is simply wrong to assimilate regulations to trade restrictions. Services liberalization, indeed, often necessitates regulation or re-regulation. But that is not to say that regulation, whether for economic or social purposes, cannot be designed, implemented or enforced in more transparent and efficient ways, with positive overall effects in terms of democratic governance.

The GATS does not prescribe the type of regulations that Governments should enact; rather, it seeks to ensure a level of transparency in Members' regulatory behaviour and to establish some basic disciplines to ensure that Members do not use regulations as a disguised restriction on trade. While the GATS allows Members to restrict trade, it requires that they do so transparently (e.g. by not making any commitments for a sector or by limiting market access under Article XVI and/or limiting national treatment under Article XVII).

It is certainly true that, as with any other legally bound undertaking in the WTO (or any other international treaty), the GATS can affect the regulatory conduct of member countries. Yet countries accept such disciplines because they deem them necessary for reaping the full benefits of international cooperation in a rules-based system. The GATS affords WTO Members considerable flexibility in this regard. For only those sectors, subsectors and modes of supply where a WTO Member agrees to schedule liberalization commitments and where exceptions to the most-favoured-nation treatment obligation have not been entered, what that country ultimately agrees to do under GATS is not to make its regulatory regime more restrictive in future (subject to trade concessions or retaliatory measures of commercially equivalent effect if a country decides, as it always can, to renege on its commitment). In scheduling commitments, WTO Members may also opt, at their discretion, to treat foreign services and service providers in a non-discriminatory manner —that is, to extend national treatment to the latter, now or in the future. And they can decide, if they so desire, to eliminate, immediately or progressively, quantitative restrictions that impede access to their services markets.[1] Each one of those decisions – like that of not scheduling commitments – remains the sovereign prerogative of WTO Members to make.

[1] Contrary to claims often made by non-governmental groups active in the environmental field, the market access provisions of the GATS (Article XVI) allow WTO Members (at the federal or sub-national level) to place quantitative limitations on the potentially environmentally harmful service operations relating for instance to oil and gas extraction, oil and gas pipelines, or waste incinerators.

Commitments under the GATS to grant market access in sectors where domestic regulation plays an especially important role do not entail any changes – and certainly not compromises – to regulatory standards or preferences. Those in force for the protection of the public, or to achieve universal access, for example in telecommunications or water supply, continue to apply regardless of the nationality of the supplier. Governments may also choose to impose additional requirements on foreign suppliers, something they typically do for instance in the case of professional licensing in medical services.

3. The GATS and investment

The GATS distinguishes between various "modes" of supplying services internationally. The third of the four GATS modes of supply refers to service supply in a member country by a supplier from another member country via a commercial presence. This may take place, for example, through the establishment of a branch office or a subsidiary of the foreign company. Services trade via this mode often takes place in conjunction with the fourth mode – the presence of natural persons – given that directors, managers, specialists and other key personnel often need to be deployed abroad (at least initially) in order to manage a foreign operation.

Services trade through FDI is particularly important, given the need for proximity between suppliers and consumers of services and the need to tailor service offerings to host market conditions. It is the area where by far the largest amount of liberalization commitments were undertaken by WTO Members in the Uruguay Round. This suggests the importance that countries attach to reaping the positive benefits – well paying jobs, human resource training, technology transfers and quality upgrading – typically associated with greater amounts of foreign direct investment (FDI) whilst also retaining the freedom to regulate such activity. There is no denying that FDI raises many sensitive issues for host Governments, in part because establishment involves foreign companies in a range of national

rules and policy issues. Nevertheless, the direction of change in host country FDI regimes has been strongly liberalizing during the last decade. More often than not, such policy changes were enacted in a unilateral manner.[2]

A number of general principles common to international investment agreements (and other agreements such as the GATT) govern the provision of services via a commercial presence under the GATS. Non-discrimination – provided for by most-favoured-nation treatment and national treatment obligations – and transparency are two fundamental GATS principles. Free transfer of payments and policy bindings (where commitments are scheduled) are also contained in the GATS. However, the GATS does not deal with some important disciplines that are traditionally included in investment agreements, such as investment incentives, performance requirements, protection against expropriation or compensation. Nor does it allow private parties direct recourse to the WTO's dispute settlement provisions, an issue that has attracted considerable attention in the NAFTA context, as it had a few years ago in the context of the MAI negotiations.

While WTO members may, via their GATS commitments, grant market access to foreign investors, they are not obliged to do so. In addition, Governments are free, if they choose to make commitments on commercial presence, to maintain existing discriminatory or quantitative restrictions. The Agreement affords no automatic right of establishment to foreign investors. The only obligations of WTO Members are to schedule any existing restrictive measure they wish to maintain in sectors where liberalization commitments are voluntarily undertaken, and to ensure freedom of payments and transfers relating to investments in such sectors.

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[2] See UNCTAD, *World Investment Report 2002 – Transnational Corporations and Export Competitiveness*, Geneva: United Nations Conference on Trade and Development, (2002).

Governments can use the GATS selectively to encourage investment in sectors of their choice, subject to the conditions they wish to impose or retain, including with respect to technology transfers and the employment of local workers. The Agreement also permits Governments to maintain foreign ownership restrictions in sectors where they have made commitments. The GATS promotes greater predictability through the permanency of commitments, an important element in attracting investment for developing countries.

The flexibility described above helps explain why the GATS tends to be viewed as the most development-friendly agreement brokered in the Uruguay Round, and why a large number of WTO Members feel that it offers the greatest scope for incrementally beefing up the WTO's treatment of investment. Two important considerations of a factual nature to bear in mind in this regard are that services make up close to two thirds of global annual FDI flows, and account for an even greater proportion of discriminatory measures affecting cross-border investment activity.[3]

[3] See Pierre Sauvé, (2001), "Scaling Back Ambitions on Trade and Investment at the WTO", in *Journal of World Investment*, vol. 2, no. 3, September, pp. 529–536.

Summary of the Expert Meeting held in Geneva from 6 to 8 November 2002[1]

In accordance with the agenda of the meeting, the discussions focused on three main areas: the role of host country policy measures; the role of home country measures; and the right to regulate and safeguards.

Experts noted that inflows of FDI could bring important benefits to the recipient economies in the form of capital inflows, technology spillovers, human capital formation, international trade integration, enhancement of enterprise development and good governance. However, it was also noted that such benefits were not automatic. In addition, some experts observed that FDI could have negative effects in such areas as market structure and balance of payments, and could lead to crowding out of domestic enterprises, as well as other social impacts. Government policies were therefore needed to enhance benefits and minimize negative effects.

When considering what host country policies could effectively help developing countries and economies in transition to attract FDI and benefit from it, experts noted that a wide range of host country policy measures were implemented, for example to:

- Create a sound and stable macroeconomic and political environment, including a transparent and predictable business environment;
- Develop physical and technical infrastructure, and promote clusters;
- Develop human resources;

[1] The summary was prepared under the responsibility of the Chairperson of the meeting, Mr. Jukka Nystén, Director, Department for External Relations, Ministry of Foreign Affairs, Finland.

- Develop domestic enterprise capabilities (notably small and medium-sized enterprises);
- Address environmental and social concerns;
- Adopt competition laws and reduce restrictive business practices;
- Influence the behaviour of investors by offering investment incentives and by imposing performance requirements (often in combination);
- Create larger markets through regional and bilateral cooperation; and
- Protect investment, including intellectual property rights.

Experts noted that the policy mix had to be adapted to the special circumstances prevailing in different countries and might have to evolve over time. Factors influencing this mix were level of development, market size, domestic capabilities and existing levels of FDI. Globalization offered better opportunities for small economies to compete for export-oriented FDI, but it also implied more competition between countries. Thus, it was becoming increasingly important for countries to consider what the best policy approach was for attracting and benefiting from FDI in accordance with their development objectives. Even at an early stage of their development, countries needed to attach importance not just to the size of FDI, but also to its qualitative aspects.

Specifically with regard to incentives, experts noted that they were widely used and were often necessary for attracting FDI and achieving development objectives. Some experts suggested that incentives might be useful for attracting a critical mass of FDI, with possible agglomeration effects. However, views on the effectiveness of incentives varied. Countries needed to take the benefits and costs of incentives carefully into account. In particular, it was stressed that in order to benefit from FDI attracted in part by the provision of investment incentives, host countries needed to pay attention to the

strengthening of domestic capabilities. Without a minimum level of absorptive capacity in host countries, the scope for positive externalities and linkages to domestic enterprises was limited. In this context, some experts made the point that countries might consider offering investment incentives in a non-discriminatory way, without distinguishing between foreign and local companies, and making incentives part of the overall industrial policy.

On the issue of performance requirements there was a divergence of views about the effectiveness of these measures. It was noted that almost all countries – both developed and developing countries – had had recourse to such requirements at some stage of their development. Specific objectives mentioned for the use of performance requirements included:

- Deepening and broadening of the industrial base;
- Generation of employment opportunities;
- Linkage promotion;
- Export generation and performance;
- Trade balancing;
- Regional development promotion;
- Technology transfer;
- Avoidance of restrictive business practices; and
- Various non-economic objectives, such as political independence and distribution of political power.

In general, performance requirements were often used to address market or policy failures. Some experts stressed the importance of information asymmetry as an argument to justify the use of such requirements. Others expressed the strong view that the determination of development priorities should be left to host countries, which should therefore have the right to impose performance requirements in order to achieve their development objectives. Some experts noted that while there might be a role

for performance requirements in the context of attracting and benefiting from FDI, the implementation and monitoring of them might entail costs and require major efforts to gather relevant information as well as to clearly define the key objectives of the measures. Some expressed the view that countries imposing too stringent performance requirements might reduce the opportunities to link up with the international production networks of transnational corporations (TNCs).

The use of some performance requirements had been disciplined by the World Trade Organization's Agreement on Trade-Related Investment Measures. As to whether countries could benefit from making the use of performance requirements more restrictive or less restrictive, experts were unable to reach a consensus. Some experts were of the opinion that it should be left to each Government – as an expression of Governments' right to regulate – to decide whether it wanted to use performance requirements, whereas others argued that further international disciplining would be in the interest of all countries.

The incidence of performance requirements in both developed and developing countries had declined over time for various reasons. It was noted by some experts that the policy mix had changed and that Governments, particularly in developed countries, were relying increasingly on other measures, such as anti-dumping and countervailing measures and strategic trade and investment policies, to achieve similar objectives. Some experts suggested that this policy change might warrant further attention.

On the issue of home country measures (HCMs), experts noted that this was an often overlooked aspect of FDI's triangular relationship, which involved TNCs, host countries and home countries. Nonetheless, HCMs could play an important role in influencing the direction, magnitude and quality of FDI flowing to developing countries, as well as the benefits that could be derived from such investment. HCMs undertaken were

typically voluntary in nature and were not bound by international agreements. There were important exceptions, however, and special reference was made to the Agreement on the Trade-Related Aspects of Intellectual Property Rights, the Lomé Conventions and the Cotonou Agreement.

Experts noted that HCMs were used primarily by developed countries, but more recently, also by some developing countries. Reflecting their objectives, HCMs could be classified into different categories:

- Policy declarations;
- Information and contact facilitation;
- Technology transfer measures;
- Financial and fiscal incentives;
- Investment insurance;
- Market access regulations; and
- Development of infrastructure and judicial frameworks.

There was no consensus among experts with regard to the effectiveness and efficiency of the various measures. Several experts remarked that there was a need for careful assessment in this regard. More analysis of how HCMs at the national, regional and multilateral levels complemented or disrupted one another was called for. Some experts stressed that HCMs were generally undertaken not only with the interest of host countries in mind, but also with a view to supporting home countries' own interests. This might constitute a problem as regards maximizing the development benefits for host countries.

It was suggested that greater attention to the role of HCMs might be appropriate in future investment agreements. Exploring ways to introduce greater consideration of developing country interests in the design and implementation of relevant HCMs could also be a beneficial avenue to consider for enhancing the developmental dimension of FDI. Finally,

several experts observed that it was important to take into account the inter-linkages between official development assistance (ODA) and FDI. For example, ODA played an important role in financing investment (e.g. in infrastructure and human resource development) that might be needed in order to create an environment conducive to FDI, but it might be difficult to raise private capital for that.

In the context of the balance between investors' rights and obligations in international investment, experts recognized that there were many different ways to address issues related to corporate social responsibility (CSR). A key distinction could be made between binding rules and voluntary codes, and another could be made between initiatives at the national and international levels respectively. The issue of linkages between CSR initiatives and the trade and investment system could be further analysed.

At the international level, a large number of initiatives had already been agreed upon. Some were universal in nature and applied to all firms (such as the International Labour Organization's Tripartite Declaration and the Guidelines for Multinational Enterprises issued by the Organisation for Economic Co-operation and Development), whereas others related to specific industries or activities. In addition, many large companies had established internal rules and codes of conduct in this area.

Views diverged with regard to what kind of approach was most effective for ensuring that CSR issues were adequately addressed in the context of FDI. Some experts favoured binding rules rather than self-regulation and voluntary codes as a means of minimizing the risk of a "race to the bottom" in the area of environmental and social standards, and because of the generally weak enforcement in host countries. Other experts argued that legally binding rules tended to be agreed upon at a lower common level of standards and might infringe the sovereign right of countries to regulate in their own interest. Some experts perceived the risk that CSR commitments might adversely affect

the ability of developing countries to exploit their comparative advantages. Also, experts discussed the potential liability of parent companies for the actions of their affiliates. Procedural difficulties were also raised in this context.

The challenge was to balance the promotion and protection of liberalized market conditions for investors with Governments' need to pursue development policies. Social responsibility standards must be applied with sensitivity to the realities of local conditions in developing countries and should not be used for protectionist purposes. It was also important that corporations operate in a regulatory framework – at the national and international levels – that was conducive to sustainable development and that did not provide incentives for mismanagement of the environment or social abuse.

It was suggested by some experts that standards for corporate responsibility should go beyond environmental and social protection and include such considerations as transfer of technology, linkages with domestic enterprises, human resources development, export promotion, consumer protection, and accounting and reporting standards.

On the right to regulate, the Meeting reviewed different concepts and interpretations in the context of liberalization and globalization. Experts recognized that international agreements might limit the sovereign autonomy of the parties. Some of these limitations might affect the ability of government to use regulation, including economic, social, environmental and administrative regulation. The tension between the need for Governments to regulate and existing international obligations was central to the question of preserving the national policy space for Governments to pursue their development objectives.

Experts reviewed the various ways in which the issue of the right to regulate had been addressed so far both in the trade area (especially in agreements such as the General Agreement on Tariffs and Trade (GATT), the General Agreement on Trade in Services (GATS), the Agreement on the Application of

Sanitary and Phytosanitary Measures (SPS) and the Agreement on Technical Barriers to Trade (TBT)) and in the investment context, particularly in bilateral investment treaties and in regional agreements such as the North American Free Trade Agreement (NAFTA). Experts agreed that in view of the difference between the impact of investment and that of trade, it was not always possible to transpose concepts and provisions that had been developed in the area of trade to the broader area of investment. In particular, the determination of development priorities should be left to host countries themselves, and the right balance should be struck between protection of investors and promotion of development. Standards for treatment of investors should be applied in such a way as to provide enough policy space for host Governments. In this regard, some experts recommended that consideration be given to the application of exceptions to take into account development concerns and to the adoption of safeguards in case of injury to the domestic enterprise sector (e.g. crowding out, balance-of-payments considerations and modifications of concessions). Some experts also suggested that the right to regulate be applied to the definition of investment by leaving out portfolio investment and to the conditions for entry and operation.

Experts also devoted attention to the issue of expropriation and regulatory takings. They recognized that expropriation provisions were essential to many investment treaties that aimed at protection of investment rather than liberalization of investment flows. Formulations in recent agreements covered not only direct takings but also anything tantamount to a taking, and entailed a requirement for full compensation. Experts also discussed issues related to litigation cases concerning this matter. Questions arose as to whether regulatory taking to protect the environment or other areas such as health, morals or human rights would also be subject to the payment of compensation. Some experts did not consider the concept or recent practice with respect to expropriation standards to be problematic.

Experts reviewed in some detail how the GATS dealt with the right to regulate, in particular by devoting attention to the interface between market access and national treatment commitments and the operation of Article VI on domestic regulation. Many service sectors were highly regulated in order to protect consumers and the environment; in the financial services sector, this regulation was to ensure a country's financial stability. Governments were cautious when agreeing to make themselves subject to common rules. Such caution was reflected in the provisions of the GATS, which upheld the fundamental right of a Government to regulate in order to pursue national policy objectives. Experts noted therefore that the experience of the GATS, in particular with regard to the commercial presence mode of service supply, which was akin in many respects to FDI, could provide a valuable insight into how to design workable provisions to safeguard the right to regulate in the context of investment agreements.

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