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Transnational Corporations
Volume 23, Number 3

Contents

ARTICLES

Palitha Konara and Yingqi Wei	Foreign direct investment as a catalyst for domestic firm development: the case of Sri Lanka	1
Matti Ylönen	Back from oblivion? The rise and fall of the early initiatives against corporate tax avoidance from the 1960s to the 1980s	33
UNCTAD	*World Investment Report 2016 – Investor Nationality: Policy Challenges*	67
BOOK REVIEW		103

Foreign direct investment as a catalyst for domestic firm development: the case of Sri Lanka

Palitha Konara and Yingqi Wei*

Foreign direct investment (FDI) carried out by multinational enterprises (MNEs) is recognized as a mechanism through which domestic firms can learn and improve competitiveness. Unlike the extant literature, which tends to focus on the aggregate effects of FDI in Sri Lanka, we investigate the role of FDI for domestic firm development at the firm level. Using World Bank Enterprise Survey data supplemented by industry data, preliminary investigation reveals that, compared with domestic firms, MNEs are larger, more productive, more profitable and more active in research and development (R&D). MNEs hire higher proportions of skilled workers and undertake more in-house training programs. They are also more export-oriented but rely more on inputs of foreign origin. The gaps between foreign and domestic firms indicate the potential that Sri Lankan firms can learn from MNEs and from FDI. The econometric study on firm-level productivity indicates positive direct effects and negative spillover effects of FDI on domestic firms. The findings have important policy implications.

Key words: foreign direct investment, multinational enterprises, Sri Lanka, productivity, spillovers

1. Introduction

In recent decades, countries around the globe have been competing to attract foreign direct investment (FDI) with the view that FDI is an engine of economic growth and FDI and its agent, multinational enterprises (MNEs), exert positive effects on domestic firms in a host country (Wei & Balasubramanyam, 2004). MNEs possess firm-specific assets such as advanced technologies, knowledge and know-how which are much desired by domestic firms, particularly those in developing countries. FDI is seen as the fastest and most efficient way to access these assets because domestic firms can be in direct contact with MNEs in the host country, which makes learning easier.

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* Palitha Konara (corresponding author) is Senior Lecturer in International Business at the University of Huddersfield. Contact: palitha.konara@hud.ac.uk Yingqi Wei is Professor of International Business at Leeds University Business School. Contact: Y.Wei@leeds.ac.uk.

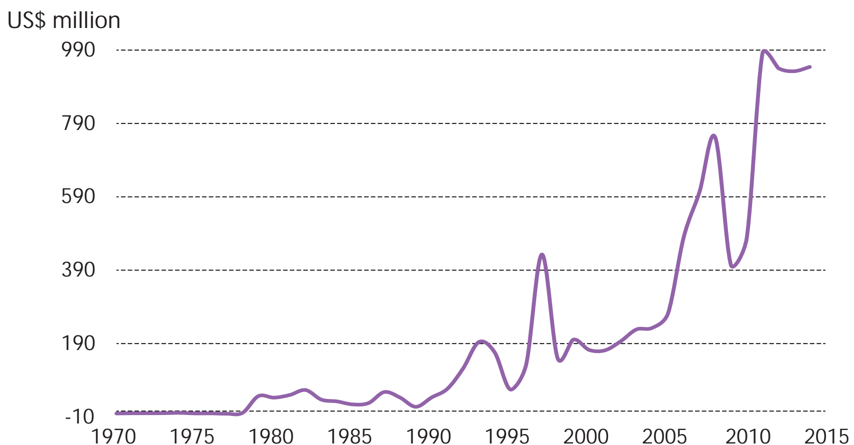
FDI can potentially improve the productivity of domestic firms through direct effects on MNE's local affiliates and through indirect or spillover effects on other domestic firms. However, this interest is not without concern that MNEs and FDI may negatively impact on domestic firms (Nam and Young, 2004). A number of reasons have been put forward, including that MNEs extort high rents; generate negative competition and monopoly effects; and bring resources, assets and practices into the host country that are inappropriate in the country context (Moosa, 2002).

There has been vibrant empirical investigation of the effects of FDI on domestic firms (see survey articles such as Iršová and Havránek (2013), Meyer and Sinani (2009) and Wooster and Diebel (2010)). The studies have produced a mixed bag of results. This has been partially attributed to different country contexts. Host-country-specific characteristics including the size of the country, its history, its stage of development, the quality of institutions and organizations, and the structure and quality of resources and capabilities embrace the gamut of characteristics affecting the role of FDI in domestic firm development. It is therefore essential to place the study of FDI in a specific country context. Against this background, we investigate FDI in Sri Lanka using firm-level data. The paper aims to answer the following question: to what extent do domestic firms differ from MNEs' local subsidiaries and benefit from FDI conducted by MNEs in Sri Lanka? Though a handful of studies have looked at FDI in the context of Sri Lanka, there is no study that compares foreign and domestic firms and examines the impact of FDI on domestic firms in Sri Lanka using firm-level data. This paper aims to fill that research gap.

Sri Lanka has long been considered, a country with excellent prospects for economic development. Post-independence, Sri Lanka was one of Asia's most promising new nations (UNCTAD, 2004). It was one of the early liberalizers in the developing world, embarking on an economic liberalization process in 1977 after a period of implementing inward-oriented policies (Athukorala, 2012; Athukorala and Rajapatirana, 2000). The reforms are fairly comprehensive, ranging from the dismantling of trade and foreign investment barriers, the unification of the exchange rate, the liberalization of interest rates and the removal of price and investment controls, to the restructuring of the tariff system and the tax system (UNCTAD, 2004). Thanks to these

outward-oriented policies, the situation of FDI was turned around from a period of slow growth or even divestment during 1966-1976, according to data published by UNCTAD (figure 1). In the 1980s, FDI jumped to an average of about US$40 million per year. This further increased to US$158 million in the 1990s. Unfortunately, the liberalization process suffered a significant setback when the Sri Lanka Freedom Party (SLFP) came to power in 2004 and started to follow statist economic policies advocating more state involvement in economic activities (Athukorala, 2012). In 2011, the Sri Lankan Government passed a controversial law in the parliament – the Revival of Under Performing Enterprises or Under Utilized Assets Act of Sri Lanka – and a few MNEs were expropriated (The Economist, 2011). This has clearly undermined Sri Lanka as an attractive location of FDI and may suggest that discomfort with and suspicion of MNEs and FDI are regaining place in policy circles. It is therefore paramount to evaluate the role of MNEs and FDI in domestic firm development in Sri Lanka and to draw policy implications based on empirical investigation.

Figure 1: FDI in Sri Lanka, US$ million



Source: UNCTAD.

The rest of the paper is organized as follows. The next section provides an overview of FDI in Sri Lanka. This sets up the context for the descriptive and econometric analysis in sections 3 and 4. The final section offers a discussion and conclusions.

2. FDI in Sri Lanka – an overview

At the time of independence in 1948, Sri Lanka compared favourably with many of today's East Asian high performers (Hossain, et al., 1999). It had and still has rich natural resources which are favoured by manufacturing industry, tourism and related services. It had a vibrant export sector, good physical infrastructure and a broad-based and efficient administrative apparatus. To this day, Sri Lanka has maintained its high level of education with an adult literacy rate of over 90 per cent, indicating a potential supply of highly trainable workers. However, following a period under an inward-looking regime and with pervasive Government intervention in business activities, Sri Lanka faced slow economic growth and negligible FDI inflows. At times, there was even divestment by MNEs. In response to this dismal economic outcome, in 1977 the administration of Janius Jayawardena explicitly committed to reintegrating Sri Lanka into the world economy. Overall Sri Lanka has since taken a fairly liberal approach towards FDI, particularly in comparison with its South Asian neighbours (Pravakar, 2006). However, this economic liberalization process has not been smooth and has been experiencing setbacks in recent years.

During the first wave of liberalization between 1977 and the early 1980s, an impressive list of measures was adopted, including restructuring the financial system, removing trade and investment barriers, lifting price controls, opening up the economy to FDI and setting up export processing zones (EPZs) (Athukorala, 2012; Athukorala and Rajapatirana, 2000). What is particularly important to MNEs and FDI was the constitutional guarantee given to foreign investors against expropriation of foreign-owned assets without compensation (Athukorala, 1995), a privilege which foreign investors enjoyed until the Government expropriated 37 private enterprises (some of which are foreign owned firms) in 2011 under the Revival of Underperforming Enterprises and Underutilized Assets Act. These outward-oriented policy initiatives played a crucial role in attracting export-oriented FDI, helping Sri Lanka broaden its export profile in light consumer goods such as garments, footwear and sports goods, and cutting and polishing imported diamonds. However, the process lost momentum in the early 1980s (Athukorala, 1995).

The second wave of the liberalization package, implemented in the 1990s, focused more on export expansion and included further tariff

cuts, simplification of the tariff structure, opening up of the current account and privatization of large State-owned enterprises (Athukorala, 1995; Athukorala and Rajapatirana, 2000; World Bank, 2007). These reforms, for example, which abolished tariffs on textiles and substantially reduced the tariffs on clothing in 1997, were instrumental for the expansion of the export-oriented garment industry, a sector that subsequently expanded to account for more than 50 per cent of exports by the 2000s (Central Bank of Sri Lanka, 2001). A new Investment Policy Statement was announced which included the set-up of a new Board of Investment (BOI), the principal government authority responsible for foreign investment. The BOI approves FDI projects, with the exception of major investments such as infrastructure projects, which still require permission from the Cabinet. The BOI has extensive authority for tax relief and administrative discretion in all matters related to FDI and can grant these concessions to firms that fulfil stipulated eligibility criteria on minimum investment, exports and employment. The establishment of the BOI helped to facilitate and speed up investment approval within a unified policy framework.

The liberalization process suffered another setback with the change in government to Sri Lanka Freedom Party leadership in 2004. There was a tendency to revert back to a dirigiste regime (Athukorala, 2012). The government espoused a shift to a mixed economy and called for re-emphasizing the role of the State and the protection of agriculture and small and medium-sized enterprises (SMEs). State control of strategic enterprises was advocated, and the role of the State was expanded by revitalizing previously closed State-owned enterprises (SOEs), imposing fresh nationalization and setting up new ventures by the Government (Athukorala, 2012; U.S. Department of State, 2015). The government also halted some of the privatizations that were in process and reversed several previous privatization projects by renationalizing them (Bureau of Economic Energy and Business Affairs, 2011). Privatization was ruled out in such industries as banking, power, energy and transportation. Finally, it is also worth mentioning the new regulations prohibiting the sale of State-owned and private-owned land to foreigners passed in February 2013 (Reuters, 2013). Until then, foreign investors could purchase land from private sellers subject to a 100 per cent tax,[1] although the Government, which owns about 80 per

[1] This tax is applicable if the foreign stake of a venture is not less than 25 per cent.

cent of the land in Sri Lanka, usually leased land on 50-year terms or on 99-year terms on a case-by-case basis (Bureau of Economic Energy and Business Affairs, 2012). These are obviously very concerning to foreign investors when making FDI decisions.

Against this policy framework for FDI, we can examine the pattern of FDI in Sri Lanka. According to data published by UNCTAD, FDI inflows between 1970 and 1976 were negligible or even negative. Performance has improved steadily since 1977, and the growth in FDI is considerable relative to the pre-liberalization era (figure 1). In the broader context, however, Sri Lanka's performance in attracting FDI has been low by the standards of the best performers in Asia (table 1) and the country has yet to regain the "investment centre in Asia" image that prevailed in the aftermath of the 1977 reform (Athukorala, 1995). For example, Malaysia, a country with a population comparable to that of Sri Lanka, attracted 12 times as much FDI inflows as Sri Lanka in 2011. Its FDI stock in that year was more than 19 times that of Sri Lanka.

Table 1. Comparative FDI Performance by Asian Country, 2011

Country	FDI Inflow (US$ million)	FDI Inflow per capita (US$)	FDI Inflow as % of GCF	FDI Stock (US$ million)	FDI Stock per capita (US$)	FDI Stock as % of GDP
South Asia						
Sri Lanka	981.10	46.62	6.12	5989.50	284.60	10.12
India	36190.40	29.15	5.90	206434.60	166.28	10.88
Pakistan	1327.00	7.51	5.54	20916.00	118.34	10.01
Bangladesh	1136.38	7.55	4.33	6165.81	40.97	5.81
Nepal	95.49	3.13	2.43	348.10	11.42	1.88
East Asia						
China	123985.00	92.01	3.72	711802.00	528.21	9.88
Hong Kong	96125.39	13496.61	180.51	1184511.36	166312.87	486.85
Korea, Rep.	10246.50	211.74	3.35	133660.00	2762.06	11.97
Southeast Asia						
Malaysia	12197.58	422.66	19.14	115063.98	3987.09	39.96
Singapore	55922.66	10779.37	91.89	625744.75	120615.43	240.81
Thailand	7778.68	111.89	8.39	150517.17	2165.14	40.71
Viet Nam	7430.00	83.68	20.44	64162.30	722.61	51.91
Philippines	1816.00	19.15	4.18	28230.00	297.62	12.56
Indonesia	19241.25	79.40	7.10	185803.73	766.75	21.94

Sources: World Development Indicators, 2013 and UNCTAD, 2013.

In the case of sectoral distribution, a majority of sectors are now open to FDI. However, Sri Lanka also maintains a list of sectors in which FDI is completely restricted[2] or is allowed only with minority stakes[3] (Bureau of Economic Energy and Business Affairs, 2012). Furthermore, FDI in several strategic sectors[4] is regulated and subject to approval by the BOI and other Government agencies (Bureau of Economic Energy and Business Affairs, 2012). Table 2 shows the sectoral distribution of FDI in selected years published by the Central Bank.[5] FDI dominated manufacturing in the initial phase of the post-liberalization era. By 1983, more than 90 per cent of realized foreign investment in BOI-registered enterprises was concentrated in manufacturing. FDI in services started picking up in 1990s, largely due to privatization (UNCTAD, 2004), and services has now become the most prominent sector. By 2011, services accounted for more than 70 per cent of total FDI stock. Agriculture, by contrast, remains largely unexplored by foreign investors.

Within manufacturing, FDI is narrowly concentrated in a few sectors. As per the ISIC Rev. 3 technology intensity definition (Economic Analysis and Statistic Division, 2011), a large share of FDI[6] took place in either medium-low-tech or low-tech industries. Furthermore,

[2] Areas of non-bank money lending, pawn-brokering, retail trade with a capital investment of less than $1 million and coastal fishing are completely restricted for foreign investments.

[3] Foreign investments in growing and processing of primary commodities, production for export of goods are subject to international quotas. Timber-based industries using local timber, deep sea fishing, mass communications, education, freight forwarding, and travel agency and shipping agency businesses are partially restricted, i.e. foreign investors are allowed to invest up to 40 per cent or a higher percentage if approval of the BOI is granted.

[4] These sectors are air transportation, coastal shipping, large-scale mechanized mining of gems and lotteries, as well as manufacture of military hardware, military vehicles and aircraft; dangerous drugs; alcohol, toxic, hazardous or carcinogenic materials; currency; and security documents.

[5] We thank a reviewer for pointing out to us an issue related to FDI statistics reported by the Central Bank of Sri Lanka. From about 2005, the Central Bank has included bank loans by foreign firms as part of reported FDI. In other words, though UNCTAD's FDI statistics include only equity capital, reinvested earnings and intracompany loans, those published by the Central Bank also include bank loans. For example, UNCTAD reported that Sri Lanka's FDI inflows in 2014 were US$944 million, but the Central Bank reported US$1,685 million, of which US$740 million were bank loans. Therefore, we interpret the Central Bank's FDI data with caution.

[6] The only exception is the chemical sector, which is categorized as a medium-high-tech industry. However, FDI in the chemical sector is not reported separately, but as part of petroleum, coal, rubber and plastic products.

export-oriented manufacturing FDI is largely concentrated in low-tech, labour-intensive industries. A majority was in the textile, garments and leather industry, which accounted for about one third of total realized manufacturing FDI in 2011, followed by the food, beverages and tobacco industry (15 per cent). However, it is worth noting here that the UN factor intensity classification is based on product nomenclature and does not take into account the production process involved.[7] Some industries that are traditionally considered to be low-tech increasingly need advanced technologies for production. A case in point is the garment industry. The Sri Lankan garment industry has made a shift from producing low value added garments to producing specialized, high-quality, up-market garments by investing in machinery and equipment and adopting new and efficient technologies (Dheerasinghe, 2003; Kapuge and Smith, 2007).

Table 2. Sectoral Distribution of Realized FDI in BOI-registered Enterprises in Sri Lanka

Sector	1983		1991		2001		2011	
	US$ million	% of total	US$ million	% of total	US$ million	% of total	US$ million	% of total
Manufacturing	**54.3**	**92.4**	**210.3**	**77.3**	**581.1**	**36.8**	**1760.9**	**29.6**
Food, beverages, and tobacco products	0.3	0.6	2.3	0.8	56.6	3.6	262.5	4.4
Textile, wearing apparel, and leather products	27.2	46.3	76.5	28.1	246.3	15.6	568.7	9.6
Wood and wood products	0.4	0.7	0.1	0.0	14.5	0.9	76.0	1.3
Paper products, publishing and printing	0.0	0.0	1.9	0.7	5.8	0.4	38.9	0.7
Chemical, petroleum, coal, rubber, and plastic products	10.8	18.3	67.5	24.8	113.9	7.2	355.8	6.0
Non-metallic and mineral products	2.0	3.4	11.7	4.3	34.9	2.2	115.0	1.9
Fabricated metal products, machinery and transport equipment	2.6	4.5	29.2	10.7	42.8	2.7	142.5	2.4
Manufactured products (nec)	11.0	18.7	21.2	7.8	66.3	4.2	201.6	3.4
Services	**4.5**	**7.6**	**61.6**	**22.7**	**999.6**	**63.2**	**4187.5**	**70.4**
Total	**58.7**	**100**	**271.9**	**100**	**1580.7**	**100**	**5948.4**	**100**

Source: Central Bank annual reports, various years.

[7] We thank a reviewer for suggesting this point.

In terms of entry mode, wholly owned subsidiaries have been preferred to other forms. According to Investment Policy Review of Sri Lanka by UNCTAD (2004), between 1979 and 2000, wholly owned subsidiaries accounted for about 60 per cent of estimated FDI by value and 45 per cent by number of projects. This pattern may influence the benefits that domestic firms can derive from FDI. It is generally believed that domestic firms benefit more from joint ventures (JVs) than from wholly owned subsidiaries. JVs are considered a more efficient mechanism for the transfer and learning of technology and knowledge, particularly for knowledge that is organizationally embedded and tacit (Wei and Balasubramanyam, 2004). JVs enable local and foreign partners to work together and exploit each other's strengths, with local partners usually contributing local knowledge and foreign partners providing advanced knowledge-based assets. The close interactions between the two parties and the transfer of knowledge-based assets from MNEs give rise to mutual learning between foreign and domestic firms.

3. A preliminary investigation of foreign versus Sri Lankan firms

Data used in this empirical study came from the Sri Lanka 2011 Enterprise Survey dataset published by the World Bank.[8] The sample frame used is the database of firms obtained from the Department of Census and Statistics of Sri Lanka, covering the non-agricultural economy and comprising manufacturing (group D); construction (group F); services (groups G and H); transport, storage, and communications (group I); and information technology, or IT (subsector 72 of group K).[9] For the survey, firms were randomly selected from the population of registered businesses on the basis of a stratified random sampling approach at three levels: industry, size and region. Thereafter, private contractors visited the chosen sample firms and collected a range of quantitative and qualitative information through the administration of questionnaires. This dataset therefore is expected to have the characteristics of representativeness and reliability.[10] However, there is criticism that some local private contractors simply covered only the

[8] http://www.enterprisesurveys.org/data
[9] Group classification is based on ISIC Revision 3.1.
[10] https://www.enterprisesurveys.org/methodology

"easy to approach" foreign firms whose head offices are in and around the central business district of Colombo.[11] This weakens the World Bank's claim regarding sample representativeness. We do not have evidence about whether the sample biases systematically affect the results. Due caution is needed in this regard.

This dataset contains information on 610 firms in both the manufacturing and the services sectors. In the questionnaire, the firms are asked to self-identify whether they are domestic or foreign firms. For certain objective questions, such as sales and employment, firms are asked for information for 2007/2008 (three fiscal years before the sampling period). Although the time dimension is short, there is abundant information at the firm level, which gives us an opportunity to compare and contrast the characteristics of foreign and domestic firms. Table 3 presents the breakdown of foreign and Sri Lanka firms in each sector. One salient limitation of this sample is that only a few foreign firms are included in some sectors, particularly in the textile, garments and leather products industry. Available evidence shows that although the number of foreign firms is low in this industry, they account for a large share of output (Kelegama and Foley, 1999).

Table 3. Distribution of Foreign and Domestic Firms by Sector

	Number of Firms		
Sector	Total firms	Domestic firms	Foreign affiliates
Manufacturing			
Food, beverages, and tobacco products	130	124	6
Textile, wearing apparel, and leather products	130	129	1
Wood and wood products	34	34	0
Paper products, publishing and printing	6	5	1
Chemical, petroleum, coal, rubber, and plastic products	20	17	3
Non-metallic mineral products	30	28	2
Fabricated metal products, machinery and transport equipment	4	4	0
Manufactured products (nec)	2	2	0
Services	246	229	17
Total	602	572	30

Source: World Bank Enterprise Survey, Sri Lanka, 2011.

[11] We thank a reviewer for drawing our attention to this point.

Table 4 lists firm characteristics differentiated by foreign and domestic ownership. In order to observe the differences between foreign and domestic firms, we regressed each characteristic on a dummy variable (FOR) that identifies whether a firm is an MNE affiliate or a domestic firm and sector-specific dummy variables that account for sector-specific differences. When the dependent variable was a binary variable, Probit estimation was used. When the dependent variable was a continuous variable, ordinary least squares (OLS) estimation was used. A statistically significant FOR variable indicates the differences between foreign and domestic firms. The test results are reported in the last column of table 4.

Foreign firms were considerably larger than domestic firms, whether measured by sales or employment. They also enjoyed substantially higher labour productivity and profitability. In terms of factor inputs, capital intensity, measured as energy consumption per employee,[12] was higher in foreign firms than in domestic firms, though the difference was not statistically significant. Whereas only a quarter of domestic firms undertook formal training programs, more than 83 per cent of foreign firms did so. For the aspect of staff turnover, however, foreign firms have a lower mean value than domestic firms, but the difference is not statistically significant. In terms of wage rate and human capital, foreign firms paid a higher nominal wage rate and employed a higher percentage of educated employees than domestic firms. However, the effective wage rate as measured by skill-adjusted wage rate was lower for foreign firms, though the difference between the two groups of firms was not statistically significant, suggesting foreign and domestic firms pay a similar level of wage for a given level of human capital.

Of the foreign firms, 30 per cent engaged in exporting and 26.7 per cent in importing, respectively, in comparison with about 8 per cent

[12] Net assets per worker – a popular measure of capital intensity in previous studies – cannot be computed, as a majority of firms have not reported the value of their net assets. Energy consumption per worker is chosen as an alternative measure. This is because capital and energy are complementary inputs in manufacturing (Globerman, et al., 1994) and energy consumption per worker has been used in several studies as a measure of capital intensity (Globerman, et al., 1994; Lipsey and Sjöholm, 2004a, 2004b, 2004c). Energy consumption is taken as the total cost of fuel and electricity for the manufacturing sector and the cost of electricity for the services sector.

and 10 per cent of domestic firms. On average, foreign firms' export intensity and import intensity were noticeably higher, indicating that foreign firms were more export-oriented and relied more on imports of foreign inputs for local production. Considering both direct and indirect exporting, foreign firms significantly outperformed local firms, with 47 per cent of foreign firms, in contrast to 16.6 per cent of domestic firms, engaged in exporting directly or indirectly. As foreign firms were active in both direct and indirect exporting, it might be the case that foreign firms exported through other foreign firms. This speculation, coupled with the higher import propensity of foreign firms, might suggest that foreign firms sourced a large proportion of their inputs either abroad or from other foreign firms in the host country. However, this speculation cannot be confidently ascertained without observing the dyadic sourcing relationships between sourcing and supplying firms.

Foreign firms tend to engage in R&D activities much more than domestic counterparts. Some 41.4 per cent of foreign firms incurred R&D expenditures compared with 11.2 per cent of domestic firms. Foreign firms also displayed a higher propensity to introduce new products or services, new or significantly improved methods, new or significantly improved logistical or business support processes, new or significantly improved organizational structures or management practices, and new or significantly improved marketing methods.

Our results are largely consistent with empirical studies conducted of other countries (Chudnovsky, et al., 2008; Domes and Jensen, 1998; Yasar and Paul, 2007). However, it is important to highlight one limitation of these comparisons. Except for sector-specific effects, we do not separately account for other factors that might be relevant to explaining each type of characteristic observed. For example, differences in labor productivity may be due to other factors, such as capital intensity and the skill intensity of the workforce. Bearing this caveat in mind, we shall investigate whether gaps between foreign and domestic firms translate to direct and spillover effects that benefit the productivity of firms in Sri Lanka.

Table 4. Comparison of Characteristics of Foreign and Domestic Firms

Characteristic	Foreign Affiliates	Domestic Firms	Estimated Coefficient of FOR[a]
Sales (rupees, million)	1006.1	199.2	762.5*** (217.1)
Employment	240	88	144.9** (60.79)
Profit (rupees, million)	313.66	62.68	187.8* (101.8)
Labor productivity (rupees, million per employee)	7.03	2.34	4.345*** (1.361)
Capital intensity (energy consumption per employee)	188.02	106.99	87.79 (168.2)
Wage rate (rupees, thousand per employee)	692.8	197.2	471.8*** (77.79)
Training firm (% of firms with formal training programs for full-time permanent employees)	83.3	25.4	1.63*** (0.29)
Staff turnover (%)	14.4	22.3	-4.976 (6.410)
Secondary education level (% of full-time permanent employees who completed secondary school)	67.3	52.3	12.56* (6.432)
Skills-adjusted wage rate (wages per worker / % of full-time permanent employees who completed secondary school)	9.6	14.5	-799.4 (11,964)
Direct exporting (% of firms exporting directly)	30	7.9	0.86*** (0.25)
Direct or indirect[b] exporting (% of firms exporting directly or indirectly)	46.7	16.6	0.996*** (0.249)
Importing (% of firms importing)	26.7	10.2	1.23*** (0.38)
Import intensity (% of inputs of foreign origin)	35.6	10.2	24.21*** (7.364)
R&D (% of firms incurring R&D expenditure during past three years)	41.4	11.2	0.909*** (0.249)
New product (% of firms introducing new products or services during past three years)	63.3	29.4	0.831*** (0.244)
New methods (% of firms introducing new or significantly improved methods during past three years)	69	42.2	0.59** (0.25)
New logistical or business support process (% of firms introducing new or significantly improved logistical or business support processes past three years)	65.5	37.7	0.58** (0.25)
New management (% of firms introducing new or significantly improved organizational structures or management practices during past three years)	70	34.4	0.79*** (0.25)
New marketing (% of firms introducing new or significantly improved marketing methods during past three years)	75.9	38.7	0.93*** (0.26)

Notes: FOR is a dummy variable reflecting whether a firm is an MNE affiliate or a domestic firm. Standard errors in parentheses in the last column. *** p = <0.01, ** p = <0.05, * p = <0.1.

[a] Regressions with sector-specific dummies included as control variables.

[b] Indirect exporting is about selling the products domestically to a third party that then exports these products to foreign countries.

4. Direct and spillover effects of FDI on labour productivity

How FDI affects the productivity of firms in a host country has been widely studied (see survey articles such as Iršová and Havránek (2013), Meyer and Sinani (2009), Wooster and Diebel (2010) and Blomström and Kokko (1998)). The effects of FDI can materialize as direct effects (or own-firm effects) or indirect (or spillover) effects (effects on other domestic firms in the host country). Direct effects capture the direct results arising from the MNE's ownership of its affiliates in the host country. MNEs, through their active role in R&D, produce, own and control a majority of the world's advance technologies, knowledge and know-how. Therefore, FDI can be a major channel through which technology transfer from advanced countries to developing countries takes place. Local MNE affiliates can enjoy higher productivity thanks to the resources, technology, and management know-how transferred from the MNE headquarters and other subsidiaries. Local affiliates can also benefit from employee training provided by MNEs and the support they receive in undertaking local R&D.

The presence of MNEs and FDI in the host country can also have an impact on other domestic firms. Positive indirect and/or spillover effects on productivity can take place through channels such as demonstration and imitation effects (foreign firms demonstrating the use of new products or processes, organizational innovation and superior management practices to other domestic firms and other domestic firms reverse-engineering from foreign firms' R&D results), competition effects (foreign firms competing against other firms, which leads to a reduction in X-inefficiency and faster adoption of new technology, knowledge and know-how), and labour turnover effects (other firms recruiting former employees of foreign firms, and the former employees of foreign firms setting up their own domestic firms) (Blomström and Kokko, 1998).

However, there are concerns about the negative effects of FDI and MNEs on domestic firms (Nam and Young, 2004). Unlike demonstration and labour turnover effects, which are presumably positive, MNEs' presence in a host country may affect competition negatively. Increased competition from foreign firms may compel domestic firms to operate

on less-efficient scales of production, which has implications for productivity for at least two reasons. First, when domestic firms lose market share, lower productivity can result from spreading fixed costs over smaller output or diseconomies of scale (Aitken and Harrison, 1999; Lipsey, 2004). Second, larger and profitable firms are in a better position to undertake R&D (Blomström and Kokko, 1998), so shrinking profits would inhibit firms from undertaking R&D to gain competitive advantages. MNEs that undertake import-substituting FDI, which occurs because of tariff and non-tariff barriers, may increase their lobbying efforts to maintain such barriers for their own advantages and survival (Loungani and Razin, 2001); as a result, domestic firms may see their productivity decrease. Overall, whether spillover effects are positive or negative is an empirical question.

Direct and spillover effects of FDI on firm level productivity are usually estimated based on the production function. In line with the previous literature (e.g. Aitken and Harrison (1999) and Vahter (2004)), we estimate the effects of FDI on labour productivity[13,14] using the following model:

$$LP_{ij} = \beta_0 + \beta_1 FOR_{ij} + \beta_2 FOR*FP_j + \beta_3 DOM*FP_j + \beta_4 SIZE_{ij} + \beta_5 SIZE_{ij}^2 + \beta_6 WAGE_{ij} + \beta_7 TRADE_{ij} + \beta_8 STATUS_{ij} + \beta_9 EC_{ij} + \beta_{10} RD_{ij} + \varepsilon_{ij} \quad (1)$$

where LP_{ij} is the labour productivity of firm i that belongs to industry j, FOR_{ij} is a dummy variable identifying whether firm i is a foreign affiliate, DOM_{ij} is a dummy variable identifying whether firm i is a domestic firm, FP is foreign presence in industry j, FOR assesses direct effects and FP spillover effects of MNEs.

[13] Owing to data limitations for input costs and capital employed, total factor productivity cannot be accurately measured; therefore, labour productivity was chosen as the measure of productivity.

[14] The linkage effect of FDI to downstream and upstream sectors could not be investigated owing to the unavailability of input-output data. However, this study uses a broad sectoral classification, i.e. a classification that is largely based on two-digit sectoral classification, and some of the two-digit sectors are grouped into broader categories; therefore some vertical relationships between three-digit or more disaggregated sectors are included within each of the two-digit sectors (Vahter and Masso, 2006). For example two-digit sectors 17 to 19 – i.e. textiles (17), garments (18) and leather (19) – are considered as one category, and therefore, vertical relationships among these three are included within the considered category. Thus, although the measured spillover effects largely represent horizontal effects, they may capture some vertical effects.

FP is interacted with both FOR and DOM in order to differentiate the spillover effects of MNEs on other foreign firms and other domestic firms, respectively. This approach was used in several previous studies; see for example Smarzynska (2002) and Chudnovsky, et al. (2008). To ensure the appropriate assessment of FDI effects, we also include a few firm- and industry-level control variables. Appendix A presents the rationale for including control variables.

SIZE and $SIZE^2$ are firm size and its squared term. WAGE is the average wage rate. TRADE is a dummy variable indicating whether firm i carries out international trade (both export and import). STATUS differentiates firms by whether they are 1) a shareholding company or a sole proprietorship or 2) a partnership company. EC and RD are capital intensity and R&D respectively. Also included as control variables are industry dummies for the following 21 sectors: food (15), tobacco (16), textiles (17), garments (18), leather (19), wood (20), paper (21), recorded media (22), chemicals (24), plastics and rubber (25), non-metallic mineral products (26), medical and optical precision instruments (33), transport machines (34), furniture (36), recycling (37), construction (45), sales, repairs, and service of motor vehicles (50), wholesale (51), retail (52), hotel and restaurants section H (55), transport (60) and IT (72). Detailed information on variable measurements and data sources is provided in table 5.

Non-random selection of FDI recipients is a major concern in estimating equation 1 (Vahter, 2004). It is often noted that MNEs tend to acquire stakes in domestic firms that have better performance or better assets or capabilities,[15] or to be drawn towards more productive industries (Smarzynska, 2002). Also, it is generally recognized that only the most productive firms can engage in FDI (Helpman, et al., 2004). Many studies have indicated the existence of this self-selection bias (Vahter and Masso, 2006). Assuming an MNE's decision to enter into FDI is dependent on certain characteristics of the firm, the following dichotomous-choice model can be formulated:

[15] This applies only for acquisitions; however, foreign firms also engage in greenfield investments when they set up new firms from scratch.

$FOR_{ij} = 1$ if $FOR^*_{ij} > 0$

$FOR_{ij} = 0$ otherwise

where $FOR^*_{ij} = \alpha_0 + \alpha_1 L3.LP_{ij} + \alpha_2 L3.SIZE_{ij} + \alpha_3 EXP_FIRM_{ij} + \alpha_4 SKILL_{ij} + e_{ij}$ (2)

L is the lag operator. The prefix L3 indicates that the variable is lagged by three years. Using lagged variables helps mitigate the endogeneity problem (see appendix A). EXP_FIRM identifies whether firm i exports or not. SKILL captures the skill intensity of workforce.

Table 5. Variable Measurement and Data Sources

Variable	Measurement
LP (Labor productivity)	Output per employee in millions of rupees
FOR (Foreign firms)	Whether or not a firm has foreign ownership: 1 if the firm's foreign equity is more than 10 percent, 0 otherwise.
DOM (Domestic firms)	Whether or not a firm is domestically owned: 1 if the firm's foreign equity is less than 10 percent, 0 otherwise.
SIZE (Firm size)	Categorical variable representing how large the firm is: 1 if a firm is a micro-firm, employing fewer than 5 employees 2 if a firm is a small firm, employing between 5 and 19 employees 3 if a firm is a medium firm, employing between 20 and 99 employees 4 if a firm is a large firm, employing more than 99 employees
WAGE (Wage rate)	Average wage rate in thousands of rupees
SKILL (Skill intensity)	Percentage of full-time permanent workers who completed secondary school education
TRADE	Whether a firm engages in international trade: 1 if the firm either exports or imports, 0 otherwise
STATUS	Firm's status: 0 if a firm is a sole proprietorship or a partnership, 1 if a firm is a shareholding company
EC (Capital intensity)	Energy consumption per employee in millions of rupees
EXP_FIRM	Whether a firm exports or not: 1 if the firm exports, 0 otherwise
RD (R&D)	Whether a firm undertakes R&D or not: 1 if the firm has spent on formal R&D activities during the last three years, 0 otherwise
FP (Foreign presence in the industry)	Cumulative realized FDI stock in each sector as of the end of 2010 in US$ million. Different measurements of foreign presence have been used in the literature including the share of the capital, employment, and output and sales of foreign firms in the sector. Many studies use the sample to calculate FP (Havranek & Irsova, 2012). We choose to use the cumulative realized FDI stock, which should capture all foreign firms, not a sample of foreign firms in a sector.

Sources: World Bank Enterprise Survey Dataset, 2011 and Central Bank of Sri Lanka, 2010.

FOR^*_{ij} is a latent variable that measures MNEs' underlying propensity to invest in firm i that belongs to industry j. FOR_{ij} is a dichotomous variable indicating whether the firm received FDI or not, taking the value of 1 if the latent variable FOR^*_{ij} is positive and taking 0 otherwise. Although the latent variable FOR^*_{ij} is not directly measurable, the indicator variable FOR_{ij} can be directly measured. Disregarding the selection model (equation 2) when the outcome model (equation 1) is estimated can lead to biased estimates of direct effects and spillover effects. To account for the selection issue, a two-stage Heckman selection model is used.

This procedure involves two steps. First, equation 2 is estimated using a Probit estimation to obtain an estimate of αs and compute the inverse Mills ratio (INVMILLS), which is thereafter included as an additional regressor in equation 1 to control for selection bias and obtain an estimate for βs. Equation 1 is estimated using OLS.[16] The residuals of equation 1 were tested for heteroskedasticity. As the results indicate heteroskedasticity, robust standard errors are employed.

Table 6 presents the descriptive statistics and correlation coefficients for the variables used in the estimations. The correlation coefficients are low among the variables in equation 1 and those in equation 2; therefore, multicollinearity is unlikely to be an issue of concern. Tables 7 and 8 show the results of the selection model (equation 2) and the outcome model (equation 1), respectively. Table 7 reveals that labour productivity is not the main factor driving the decision to enter into FDI; skill intensity, firm size and export orientation are more important.

Table 8 presents the results that are of particular interest to us. Columns 1 and 2 show the results without accounting for the self-selection issue for comparison. In columns 2, 3 and 4, industry-specific and/or region-specific fixed effects are included to control for unobserved industry-specific and/or region-specific effects. Note that the estimated coefficients of inverse Mills ratio are negative and significant in columns 3 and 4, indicating that self-selection is prevalent and highlighting the importance of correcting for the selection bias. Previous studies – for example, Aitken and Harrison (1999) and Marin

[16] For further explanations about this procedure, see Heckman (1979) and Smarzynska (2002).

and Bell (2006) – have warned that when FDI takes place in highly productive sectors, there can be a positive association between foreign presence in the sector and the productivity of domestic firms in the same sector. Our results, thus, reiterate the importance of controlling for industry-specific effects and addressing the self-selection issue. Comparing columns 3 and 4, which present results without and with regional dummies, the results are qualitatively similar. This is unsurprising because Sri Lanka is a relatively small country. Therefore, firms are likely to consider all of Sri Lanka as one market and pay little attention to regional differences.

Table 6. Descriptive Statistics and Correlation Matrix

		Descriptive Statistics				Correlation Matrix									
	Variable	Mean	SD	Min	Max	1	2	3	4	5	6	7	8	9	10
1	LP	2.58	6.98	0.025	80										
2	FOR	0.05	0.22	0	1	0.15									
3	FP	1494.97	1443.11	35	3221.9	0.08	0.06								
4	SIZE	1.67	0.77	1	3	0.06	0.23	-0.02							
5	SKILL	53.08	34.09	0	100	0.08	0.07	0.24	0.08						
6	WAGE	220.72	407.60	5.455	5333.3	0.22	0.20	0.08	0.08	0.04					
7	TRADE	0.16	0.37	0	1	0.11	0.20	-0.22	0.40	0.05	0.11				
8	EXP_FIRM	0.09	0.29	0	1	0.06	0.18	-0.09	0.36	0.08	0.12	0.72			
9	STATUS	0.20	0.40	0	1	0.20	0.22	0.03	0.39	0.08	0.18	0.25	0.20		
10	EC	110.92	836.14	0	18157.8	0.25	0.03	-0.06	0.04	-0.07	0.16	0.13	0.02	0.01	
11	RD	0.13	0.33	0	1	0.15	0.22	0.02	0.36	0.05	0.12	0.20	0.22	0.21	0.14

Table 7. Results of the Probit Estimation of the Selection Model for FDI

Dependent Variable: FDI	
L3.LP	0.00542
	(0.00485)
L3.SIZE	0.291**
	(0.133)
EXP_FIRM	0.552*
	(0.289)
SKILL	0.00717**
	(0.00339)
Prob > chi2	0.0003
Pseudo R-squared	0.1177
Number of observations	476

Note: Standard errors in parentheses; *** p = <0.01, ** p = <0.05, * p = <0.1

Table 8. Results of the Outcome Model for Labor Productivity

	(1) OLS	(2) OLS	(3) Heckman	(4) Heckman
FOR	7.407**	7.950**	8.537*	8.709*
	(3.336)	(3.399)	(4.449)	(4.306)
FOR*FP	-0.00219*	-0.00386***	-0.00420***	-0.00425**
	(0.00113)	(0.00104)	(0.00135)	(0.00173)
DOM*FP	0.000503*	-0.00105***	-0.00140***	-0.00134**
	(0.000248)	(0.000116)	(0.000212)	(0.000523)
SIZE	3.507	3.236	4.117	3.975
	(3.270)	(3.816)	(3.833)	(3.884)
$SIZE^2$	-1.096	-1.035	-1.598	-1.513
	(0.942)	(1.108)	(1.112)	(1.088)
WAGE	0.00259**	0.00274**	0.00309	0.00263
	(0.000953)	(0.00111)	(0.00182)	(0.00190)
TRADE	1.141	1.284	0.406	0.218
	(0.894)	(1.086)	(1.141)	(1.204)
STATUS	2.480**	2.431**	2.991**	2.423*
	(0.888)	(0.974)	(1.168)	(1.253)
EC	0.00170***	0.00168***	0.00188***	0.00188***
	(0.000187)	(0.000189)	(0.000138)	(0.000135)
RD	1.402	1.517	1.691**	1.536*
	(0.991)	(0.932)	(0.803)	(0.749)
INVMILLS			-3.990***	-3.795**
			(1.379)	(1.521)
Industry fixed effects	NO	YES	YES	YES
Regional effects	NO	NO	NO	YES
R-squared	0.165	0.192	0.216	0.235
Number of Observations	525	525	454	454

Notes: Robust standard errors in parentheses; *** p<0.01, ** p<0.05, * p<0.1

FOR is positive and significant in all specifications in columns 1 through 4, indicating the direct effects of FDI. The finding is consistent with previous studies of other countries (Chudnovsky, et al., 2008; Domes and Jensen, 1998; Lipsey, 2004; Yasar and Paul, 2007). Given the importance of technological progress to individual firms for their competitiveness and to the country for its development, it might be cost-effective for Sri Lankan firms to use existing technologies in the

developed world. Through working directly with MNEs, firms in Sri Lanka are exposed to foreign technologies, and their productivity improves as a result.

FDI*FP is negative and significant in all specifications, indicating negative intra-industry FDI spillover effects on other foreign firms. This result is broadly consistent with the findings of past empirical studies. For example, Chudnovsky, et al. (2008), on the basis of firm-level data on Argentina, find that foreign firms have negative spillovers on other foreign firms. Chuang and Lin (1999) also show weak spillovers on other foreign firms using Taiwanese firm-level data. DOM*FP is positive and significant for the specifications that do not control for self-selection and industry fixed effects (column 1). In contrast, when industry fixed effects are included (columns 2, 3 and 4), this interaction term turns negative and highly significant. Given the significance of INVMILLS, we infer that foreign firms have a negative spillover effect on the productivity of domestic firms.

We now turn our attention to control variables and summarize our findings briefly. As expected, SIZE is positive and $SIZE^2$ is negative in all specifications; however, they are statistically insignificant. WAGE and R&D are positive and significant in some specifications, indicating the importance of firm-level labour quality and R&D activity on productivity. TRADE is positive in all specifications but statistically insignificant. EC and STATUS are both positive and statistically significant in all specifications. Thus, capital-intensive firms are more productive. Shareholding companies are more productive than sole proprietorships or partnerships.

Some of the recent studies on productivity spillovers have emphasized the importance of accounting for the non-normal distribution of firm productivity in the sample (Damijan, et al., 2013; Dimelis and Louri, 2002; Girma and Görg, 2007). If firm productivity in the sample is not normally distributed, which is usually the case because there is large and persistent heterogeneity in labour productivity across firms even within narrowly defined sectors (Girma and Görg, 2007), quantile regression that allows the examination of FDI's effects at different points of the conditional distribution of labour productivity would be preferred to standard least squares. In other words, quantile regression permits the investigation of the relative importance of

explanatory variables across the whole distribution of the labour productivity variable in comparison with the central tendency of the variable by taking into account the large and persistent heterogeneity in productivity across firms. Formal testing for normality using the Shapiro-Wilk normality test and the Shapiro-Francia normality test leads to a rejection of the null hypothesis of normality. Quantile regressions were estimated and the results are reported in table 9.

Table 9. Results of the Quantile Regressions with Heckman Treatment Effects

	(1)	(2)	(3)	(4)	(5)
	10th quantile	25th quantile	50th quantile	75th quantile	90th quantile
FOR	-0.0330	0.0228	1.844**	0.626	71.50***
	(0.144)	(0.450)	(0.871)	(1.523)	(2.515)
FOR*FP	-0.00003	-0.000129	-0.00105***	0.000323	-0.0239***
	0.00006	(0.000144)	(0.000338)	(0.000627)	(0.000843)
DOM*FP	-0.00002	-0.00004	-0.000353***	-0.000437***	-0.00152***
	0.00003	0.00004	(0.000136)	(5.58e-05)	(0.000534)
SIZE	0.0656	0.102	0.0599	0.832	6.209
	(0.0681)	(0.178)	(0.331)	(0.808)	(4.018)
$SIZE^2$	-0.0277	-0.0573	-0.0789	-0.334	-2.016*
	(0.0202)	(0.0602)	(0.0715)	(0.227)	(1.082)
WAGE	0.00103***	0.00166***	0.00260***	0.00391**	0.0101
	(0.000394)	(0.000307)	(0.000582)	(0.00160)	(0.0106)
TRADE	0.0111	-0.0211	0.161	0.325	-0.273
	(0.0345)	(0.0718)	(0.200)	(0.430)	(1.337)
STATUS	0.0487	0.125	0.681*	1.367	4.080**
	(0.0526)	(0.103)	(0.357)	(1.288)	(2.047)
EC	0.00184***	0.00196***	0.00189***	0.00177***	0.00136**
	(0.000318)	0.00002	0.00002	(0.000115)	(0.000543)
RD	0.0207	0.00859	0.188	0.795	1.176
	(0.0518)	(0.0898)	(0.283)	(0.872)	(1.202)
INVMILLS	-0.0387	-0.185	-0.388	-0.781	-3.827**
	(0.0588)	(0.120)	(0.334)	(0.518)	(1.799)
Industry fixed effects	YES	YES	YES	YES	YES
R-squared	0.084	0.098	0.140	0.159	0.119

Notes: Sample size = 454; Robust standard errors in parentheses; *** p<0.01, ** p<0.05, * p<0.1

The results largely remain intact except for a few minor differences in some quantiles. FOR remains positive for all quantiles except the 10th, where the coefficient estimate is negative but insignificant. This is unsurprising because MNEs' participation is likely to be low in industries with very low productivity. Those who do participate in such industries are unlikely to be superior to their domestic counterparts. Compared with other quantiles, the coefficient estimate of FOR for the 90th quantile is very large and highly significant. This shows that foreign firms enjoy high productivity relative to domestic firms in the upper end of the distribution.

In line with the results in table 8, FDI*FP remains negative for all quantiles except for the 75th quantile, where the coefficient estimate is positive but insignificant. DOM*FP is negative in all estimations. However, the negative coefficients are significant in the median and higher quantiles but insignificant in lower quantiles. This clearly indicates that negative spillovers are stronger in higher quantiles. With respect to control variables, all results remain consistent with those in table 8. The inverse Mills ratio is negative in all quantiles, but only significant in the 90th quantile. This implies that self-selection is more prevalent in the upper end of the distribution.

5. Discussions and conclusion

With regard to the role of FDI in developing host countries, broadly speaking, there are three perspectives: the "Washington Consensus" enthusiasm, academic scepticism and dirigisme resurrected (Moran, et al., 2005). The first considers FDI as a major channel for host-country development and, therefore, holds the view that host-country governments should attract and incorporate FDI into their development strategies. To academic sceptics, the nature of FDI is no different to other kind of investments; therefore, there is no point in devoting scarce domestic resources to FDI promotion. The third perspective sees that "host-country development objectives can be achieved only by imposing performance requirements on multinational investors" (Moran, et al., 2005). According to Athukorala (2012), recent developments in the Sri Lankan policy scene shows a pattern of reverting to dirigisme. It is therefore timely to empirically assess FDI in Sri Lanka.

In line with previous empirical studies conducted on other countries (e.g. Yasar and Paul,2007; Chudnovsky et al., 2008; and Domes and Jensen, 1998), comparison of foreign and domestic firms in Sri Lanka reveals that foreign firms are distinct from domestic firms. Foreign firms are larger, more productive, more profitable and more active in R&D. Foreign firms tend to hire higher proportions of skilled workers and undertake more in-house training programs. They are more export-oriented but rely more on inputs of foreign origin. These findings therefore indicate the potential that firms in Sri Lanka can learn from MNEs, challenging the validity of academic scepticism.

The results of an econometric study based on the World Bank's Enterprise Survey data provide strong evidence of positive direct effects of FDI but negative spillover effects on domestic firm productivity. Given the Sri Lankan context, this might not be surprising, for several reasons. First, the literature on productivity spillovers recognizes that the extent of spillovers depends on the degree to which foreign affiliates are technologically active in the host country (Marin and Bell, 2006). As shown in section 2, FDI in Sri Lanka has primarily taken place in low-tech sectors. Therefore, the potential for spillovers may be limited.

Second, the extent of spillovers depends on the degree to which foreign affiliates expose their technologies (technology leakage) to other domestic firms (Marin and Bell, 2006). Available evidence on the textiles and clothing industry shows that domestic firms' linkages to MNEs are weak (Kelegama and Foley, 1999). Moreover, the higher import propensity of foreign firms and higher import content of the inputs used by foreign firms, as shown in section 3, could limit the opportunities for domestic suppliers to learn from MNEs and benefit from potential positive spillovers.

Third, the literature on productivity spillovers recognizes that spillover effects depend on the level of absorptive capacity of domestic firms (Damijan, et al., 2013; Marin and Bell, 2006). The industrial structure in Sri Lanka is narrowly concentrated in a few sectors, with little participation in technology-intensive sectors, which indicates that the overall technical knowledge of domestic firms is low. Available evidence also demonstrates that, although Sri Lanka enjoys very good human capital indicators (e.g. secondary education attainment and literacy), only a few technical graduates are produced and retained in the

country. There is a mismatch between the skills needed by employers and the education provided by the secondary school system and public universities (Ganegodage & Rambaldi, 2011). Our discussion in section 3 shows that compared with foreign firms, only a smaller percentage of domestic firms undertake R&D or in-house training programs. These factors indicate a low absorptive capacity of local firms. Finally, the discussion in section 3 also reveals that foreign firms experience low staff turnover, which again lessens the extent to which foreign affiliates expose their firm-specific assets to domestic firms.

In summary, given the Sri Lanka context, it is unsurprising to see that MNEs help improve the productivity of their affiliates in Sri Lanka but exert competition effects on other domestic (and foreign) firms, while generating limited positive spillover effects through the channels of demonstration, linkage and labour turnover. As the result of the dominance of negative competition effects over other spillover effects, we observe the negative impact of FDI on productivity of other domestic firms.[17]

The findings of this study have important implications for the development of domestic firms. Foreign firms, through their distinctive characteristics, are likely to bring much-needed expertise and skills that could help to overcome the structural deficiencies of the country's industrial structure. However, Sri Lanka's mediocre performance in attracting FDI, particularly FDI in technology-intensive sectors, and the absence of positive spillovers from MNEs to domestic firms may all have resulted in poor performance by domestic firms in upgrading firm-specific capabilities. The goals of the national FDI policies are twofold. First, a country should attract the right type of FDI. Second, a country should devise appropriate policies to extract benefits from the presence of foreign MNEs. It appears that Sri Lanka has performed poorly in both of these aspects, and this has, in turn, deprived the country of much-needed skills and technologies and decelerated its development.

Despite its merits, this study is not without limitations, mainly owing to a few issues inherent in the Enterprise Survey data. We relied largely on cross-sectional data owing to the unavailability of panel

[17] The negative coefficient on FP could also be interpreted as the result of self-selection. However, the lack of panel data with longer time dimension prevents us from further testing the idea.

data. However, using responses received from respondents about past data, several tactical measures were taken to minimize endogeneity and self-selection bias, and thereby, largely minimize the well-known limitations of using cross-sectional econometrics. Second, the number of foreign firms is limited and for some, survey data may be collected because they are “easy to approach”; therefore, foreign firms might not be well represented in some of the sectors. We tried to minimize the effect of this limitation by measuring foreign presence by cumulative realized foreign investment instead of calculating foreign presence based on the sample. Another limitation is that there seems to be an underrepresentation of exporting firms in the sample for some industries; for example, only 9.2 per cent of firms were exporting firms in the textile, wearing apparel and leather products industry, which is largely export-oriented. Therefore, the findings of this study might have more relevance to import-substitution (market-seeking) FDI than to export-oriented FDI.

Appendix A. Control Variables in Outcome and Selection Equations

Previous literature guided our choice of the control variables in the outcome equation (equation 1) and the selection equation (equation 2).

SIZE and $SIZE^2$ are included in equation 1 as economies of scale can affect productivity positively and diseconomies of scale can affect productivity negatively; thus, the relationship between SIZE and productivity can be non-linear (Ganotakis and Love, 2012). WAGE is a proxy for the skill intensity of a firm's workforce and is commonly used as a measure of labour quality (Blomström, 1988). TRADE is included because technology transfer and diffusion can take place through not only FDI but also international trade linkages (Smarzynska, 2002). This is because firms that export and import come into contact with new technologies. Exporting firms have to compete with firms with world-class practices and therefore need to be more efficient. Exporting firms may also have a better opportunity to achieve economies of scale and to better utilize internal capacity, which could lead to increase in productivity (Makki and Somwaru, 2004). In contrast, firms that solely depend on the domestic market may not be able to achieve optimum productive efficiency because of the small market size of Sri Lanka. Importing firms can acquire intermediate goods of high quality, which in turn improve their productivity. Importing firms can also carry out reverse engineering of technologies that they come across when interacting with foreign suppliers. As existing research shows that ownership structure can have implications on firm productivity (Barth, et al., 2005; Hill & Snell, 1989), we include STATUS. The rationale for including EC is that, as capital available for each unit of labour (capital intensity) increases, labour productivity increases (Hill and Snell, 1989). R&D activities contribute to the firm's stock of accumulated knowledge and thus contribute to improvements in product or service quality and to reductions in the production and/or operation cost of the firm, thereby improving the productivity of firms (Hill and Snell, 1989).

In line with previous studies (e.g. Vahter (2004)), four explanatory variables are included in equation 2: L3LP, L3SIZE, SKILL and EXP_FIRM. Foreign firms are inclined to invest in local firms that are more productive

ex ante, which is commonly referred to in the literature as the cherry-picking phenomenon (Hanousek, et al., 2011). However, some studies tend to use the same variables in both the outcome and the selection equations. For example, Vahter (2004), studying the effects of FDI on labour productivity, uses the same labour productivity measure in both the selection equation and the outcome equation. This can create an endogeneity issue. The World Bank's Enterprise Survey includes two questions that ask respondent firms for the amount of sales generated and the number of workers employed in 2007/2008 (three fiscal years before the sampling period). Using this information, L3.LP, i.e. three-year lagged labour productivity, is constructed and used in the selection equation, instead of contemporaneous labour productivity. This approach can help mitigate the endogeneity problem. Along similar lines, instead of including the variable SIZE in the selection equation, L3.SIZE is included. Some studies point out that foreign firms can also self-select into more capital-intensive firms or industries (e.g. Domes and Jensen (1998)). Therefore, energy consumption per worker (EC) was initially used in equation 2. However, EC was statistically insignificant, so it was subsequently dropped from the selection equation.

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Back from oblivion? The rise and fall of the early initiatives against corporate tax avoidance from the 1960s to the 1980s

Matti Ylönen*

Tax havens and tax avoidance have gathered much interest, e.g., in the United Nations (UN) negotiations on the post-2015 development goals. The analyses of initiatives against corporate tax avoidance typically focus on developments from the mid-1990s onward. This article shows that contrary to the common perception, the country-by-country reporting initiative and many of the other contemporary policy responses had already been developed and discussed in the 1970s by the United Nations Commission and Centre for Transnational Corporations. I demonstrate how the weakening of the policy community of the UN and the failure of the Organisation of Economic Co-operation and Development (OECD) to refer to the earlier discussions, not only in the UN but also in the OECD, contributed to the passing into oblivion of these ideas. Other factors were the reframing of the UN work on multinational enterprises to human rights issues and the transformation of academic theories of the firm. The examples demonstrate how ideas shape world politics and how the oblivion of certain ideas can have concrete impacts on the power relations between its actors. The oblivion of the earlier debates paved the way for the triumph of more business-friendly discourses centred on the anti-corruption and corporate social responsibility arguments.

Keywords: United Nations, transnational corporations, development, transfer pricing, country-by-country reporting, accounting

* Matti Ylönen is a doctoral researcher at the Department of Political and Economic Studies (World Politics), University of Helsinki; and Aalto University School of Business; and currently also a PhD Intern at the United Nations University World Institute for Development Economics Research UNU-WIDER. Contact: tel. +358 40 723 11 18; e-mail. matti.ylonen@aalto.fi

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1. Introduction

Transnational corporations should/shall not, contrary to the laws and regulations of the countries in which they operate, use their corporate structure and modes of operation, such as the use of intra-corporate pricing which is not based on the arm's length principle, or other means, to modify the tax base on which their entities are assessed. – Draft United Nations Code of Conduct on Transnational Corporations, 1983

Exchanges of information between tax administrations through the application of tax agreements could not be regarded as a very effective method of putting an end to the flight of capital, and more comprehensive international co-operation was therefore required in that field. – United Nations Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, 1970

In September 2013, the G20 group mandated that the Organisation for Economic Co-operation and Development (OECD) start the Base Erosion and Profit Shifting (BEPS) project, which aimed to produce international tax rules that would tax transnational companies (TNCs) where economic activities take place and where value is created. This marked the start of an intensive two-year negotiating process, with the outcome documents agreed upon and published in October 2015. The rules that govern intracompany trade received some fixes and improvements, and a few pressing initiatives, such as country-by-country reporting, saw significant progress. However, the results failed to impress critical observers, as much of the present corporate tax avoidance will continue unabated even after the BEPS resolutions take effect (BEPS Monitoring Group, 2015).

Despite its deficiencies, the BEPS process can be seen as the culmination of the OECD-led efforts to champion the international tax regime (Ring, 2007: 598), especially since the publication of the OECD's *Harmful Tax Practices* report in 1998 (OECD, 1998). The report was an answer to the 1996 call from the G7 countries to develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases.[1]

[1] Specifically, the 1998 report set out a proposal to establish guidelines on the identification of harmful preferential tax regimes, called for the creation of a forum on harmful tax practices, called for the development of a list of tax havens and suggested a number of recommendations for action at the level of national legislation and in tax treaties.

Since then, the history of anti-tax haven and anti-tax avoidance initiatives has usually begun with reference to that 1998 report, which had the bold subtitle of *An Emerging Global Issue* (OECD, 1998; see also Eccleston, 2012: 100; Eden and Kudrle, 2005: 107–108; Hampton and Christensen, 2002: 1659; Weiner and Ault, 1998: 601).

This is not a big surprise, as the 1998 report made no reference to any studies published prior to the 1980s. Illustratively, the first sentence of the introduction set the general tone, stating that "historically, tax policies have been developed primarily to address domestic economic and social concerns" (OECD, 1998: 13). Ironically, the OECD even failed to refer to some its own earlier work to counter tax avoidance and tax evasion. However, this article demonstrates the need to look further back in history in order to understand both the origins of the policy discussions on tax havens and the initiatives to tackle the international tax flight. Specifically, the article illuminates the rich body of analyses and policy initiatives produced by the various agencies and groups under the United Nations (UN) umbrella. I show how the UN and its Centre for Transnational Corporations (UNCTC) originally developed, considered and promoted many of the initiatives that have gained prominence especially in the post-financial crisis era.

With this exercise, I provide new information for the intensifying policy-focused and analytical debates on tax havens, tax evasion and tax avoidance (e.g. Christensen and Murphy, 2004; Christensen, 2011; Dietsch and Rixen, 2016; Palan et al., 2013; Picciotto, 2011; Pogge and Mehta, 2016; Slemrod and Wilson, 2009). Moreover, I aim to provide historical context for research on the initiatives that tackle the problems caused by tax havens, international tax evasion and corporate tax avoidance (Eden and Kudrle, 2005; Hasseldine and Morris, 2013; Murphy, 2007; Murphy, 2009; Preuss, 2010; Seabrooke and Wigan, 2013; Sharman, 2006; Sikka, 2010; Sikka, 2013; Spencer, 2014). Indeed, a common feature of many of these analyses has been that they discuss the growth of tax havens and corporate tax avoidance in the context of recent economic and financial globalization. Finally, the article contributes to the discussions about the epistemic communities, emergent entrepreneurs and the role of ideas and memory in the studies of international relations and international political economy.

The demise of theoretical work on the societal powers of corporations in past decades has most likely reinforced these tendencies. Some inadequately resourced work conducted by UNCTAD notwithstanding, the UN had effectively withdrawn from working on the political and power aspects of TNCs in 1998. Moreover, the UN abandoned its work on the United Nations Code of Conduct on Transnational Corporations (CoC) in the early 1990s, rebuilding its work in this field with a less controversial angle on business and human rights in the late 1990s. Against this background, it is no surprise that the late 1990s and early 2000s saw a rediscovery of some of the initiatives developed in the 1970s, but this time in the context of human rights, good governance and anti-corruption efforts. It took the global financial crisis of 2007–2009 to push world leaders to gear up international policy work to a level distantly comparable with the UN efforts, but this time steered especially by the OECD. In addition to these findings, this article contributes also to the discussion on private global governance. I suggest that the International Accounting Standards Committee (IASC) has had an important role in providing an excuse for scaling down the UN work on regulation of international accounting.

This study draws on a large body of research. The material includes the key academic publications and UN policy documents from the late 1960s to the early 1980s. I selected the policy-related material by reviewing all the relevant material issued by the UN and the UNCTC and the reports and documents that preceded its creation. Not all UNCTC publications were used, as I focused the analysis on those reports with the most significance for the subject.[2] The documents were fetched from the website archive.org, as the UNCTC website (unctc.unctad.org) of UNCTAD was no longer operational. Finally, as background work for this article, I conducted semi-structured interviews of Klaus Sahlgren and Kari Tapiola in the summer of 2015[3] in Finland. Mr. Sahlgren was the first Executive Director of the UNCTC (1975–1983), and Mr. Tapiola was the Special Assistant to the Executive Director of the UNCTC (1976–1978).

[2] The UNCTC published 265 documents during its existence (Hamdani and Ruffing, 2015: 49). There are necessarily gaps in the content of this article. However, enough information has been provided to establish a revelatory (Yin, 2003: 42) case study that provides enough material to question the earlier understanding of the phenomenon that is being researched.

[3] Sahlgren was interviewed in Korppoo and Tapiola in Helsinki.

The early discussions on international tax avoidance and tax evasion emerged from three main sources in the late 1960s and during the 1970s. Of these, the most important were material produced by international agencies, especially the UN, as well as some notable work by the U.S. scholars. Moreover, these discussions were reflected in the domestic policy debates in the United States, such as the initiatives by the Kennedy administration and the hearings of the U.S. Senate on these topics (Rixen, 2010: 17; Webster, 1961). Since the 1910s, the international community had been addressing the phenomenon of double taxation in the League of Nations, the International Chamber of Commerce and other supranational bodies (Rixen, 2008: 88; Rixen, 2010). Only after the problem of double taxation had been at least somewhat resolved did the issue of undertaxation became relevant (Rixen, 2010: 4).

In the 1960s and 1970s, the most important policy initiatives focused on the accounting rules of TNCs and on model tax treaties. I start by presenting the organizational setting of the early attempts to develop an international anti-tax avoidance regime and then review the key discussions and materials produced by the UN organizations and the OECD. These documents were significant in providing far-reaching analyses of tax havens, tax avoidance and tax evasion, and in advocating various reforms to the international corporate tax systems, including the initiative for country-by-country reporting as well as the proposal for unitary taxation and discussion on automatic, multilateral exchange of information. All of these initiatives are currently discussed in various international bodies without proper awareness of their history. I contrast the early UN discussions with the aims of the OECD's BEPS project, as well as to the 1998 *Harmful Tax Practices* report. I argue that although the UN efforts related to regulating TNCs are relatively well known within the scholarship on development studies and global political economy studies, there has been a lack of substantial analysis of the UN proposals that would have benefited later research on tax avoidance and evasion.

2. The organizational setting and the work on exchange of tax information

After heated and unsuccessful discussions in the UN's newly formed Economic and Social Council (ECOSOC), the post-World War II work on international taxation became an OECD-led initiative with an explicit focus on eliminating double taxation (Picciotto, 1992: 48–51; Rixen, 2008: 96–97). In contrast to the Keynesian mainstream of the time, the OECD generally advocated laissez-faire stances in much of its economic policy (Williams, 2008: 118). In 1956, the OECD's Fiscal Committee, made up of government officials and tax experts, began to elaborate a draft convention with the aim of providing solutions to the problem of double taxation among OECD member countries. The outcome of the Committee's work was adopted in July 1963 under the title *Draft Double Taxation Convention on Income and Capital*. While focusing on double-taxation issues, the convention also contained articles regarding the elimination of discriminatory tax provisions in internal laws and the reduction of international tax avoidance through the exchange of information between national tax administrations (Surrey, 1978a; Rixen, 2008).

In addition, the OECD also briefly addressed tax and development issues in its report titled *Fiscal Incentives for Private Investment in Developing Countries* (OECD, 1965). Although mostly faithful to its title, the report also noted how it is of major importance for a capital importing country to adopt provisions which would keep it from becoming a tax shelter for investors from industrialized countries. Moreover, the report highlighted the problems caused by round-tripping capital: capital that is first transferred out from and then back to the country of origin in order to gain tax benefits (OECD, 1965: 55). What is more, it also noted the importance of establishing tax treaties with developed countries (OECD, 1965: 58). However, the report did not provoke further research by the OECD at the time. With the exception of the OECD work on tax treaties, the UN soon took the lead in developing analyses of and initiatives against corporate tax avoidance and evasion.

The UN work occurred in two partially overlapping processes. The first originated from the Economic and Social Council's resolution 1273 (XLIII) in August 1967, which requested the Secretary-General to set up an ad hoc working group consisting of experts and tax

administrators to explore ways and means for facilitating the conclusion of tax treaties between developed and developing countries. Made up of representatives nominated by governments, this working group published several reports in the 1970s. The second strand of the UN work arose from the UN efforts to regulate the operations of TNCs and was in part directed to addressing accounting issues. Establishing new international accounting standards was one of the priorities for dealing with the challenges created by TNCs. This process fed into the UN Code of Conduct on Transnational Corporations, which was negotiated for several years but finally abandoned in the early 1990s.

The Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries was composed of 20 tax officials and experts nominated in their personal capacity.[4] The Group convened in 11 meetings from 1968 to 1977 to pursue the task of exploring ways and means for facilitating tax treaties between developing and developed countries "including the formulation, as appropriate, of possible guidelines and techniques for use in such tax treaties which would be acceptable to both groups of countries" (Economic and Social Council resolution 1273 (XLIII), August 1967, quoted in UN, 1979). Subsequently, in 1974, ECOSOC emitted a resolution stating that the provisions that the Group had been working on "could be standardized, with only a small number of clauses to be negotiated in particular cases, they would in fact amount to an international agreement on taxation, which … [would be] the final objective". The work then culminated in the draft model double-taxation treaty accompanied with a manual for implementation, first published in 1980. Based on this draft, the UN secretariat then produced the model convention that reproduced the Ad Hoc Group's work, which itself was built partially on the double-tax convention that the OECD had produced (Surrey, 1978a).

By its resolution 1980/13 of 28 April 1980, ECOSOC renamed the Group of Experts as the Ad Hoc Group of Experts on International Cooperation in Tax Matters. After a period of inactivity, the group reconvened in 1997 and was renamed again in 2004 as the Committee of Experts on International Cooperation in Tax Matters – commonly

[4] These countries were initially Argentina, Chile, France, Germany, Ghana, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, the Sudan, Switzerland, Tunisia, Turkey, the United Kingdom and the United States. In later years, the membership varied and was expanded further.

referred to as the UN tax committee (Rixen, 2008: 147–148; UN, 2002). Though inadequately resourced and relatively poorly known outside tax policy circles, the UN Tax Committee still updates the Model Tax Treaty. The UN version gives more taxing rights to source countries, whereas the OECD's treaty leans more towards the residence principle (Surrey, 1978a). In this way, the UN Model Treaty is more favourable for most of the developing countries. From early on, the Group stressed many of the concerns that are familiar from the contemporary debates (UN, 1969, 1970, 1972, 1973, 1975, 1976, 1978, 1979). Even though the group had a special focus on tax information exchange, it touched upon many other issues – from tax havens to transfer pricing, which was the special concern of the 1975 report (UN, 1975: 14).

At the July 1972 meeting of ECOSOC, the Chilean representative required the UN to appoint a high-ranking expert commission to study the role of multinational corporations (Rahman 1998: 595; Sagafi-Nejad et al., 2008: 43–47). The call was ignited by a 1971 U.S. Senate subcommittee report that confirmed the alleged involvement of the International Telegraph and Telephone Corporation (ITT) in destabilizing the democratic government of Salvador Allende in Chile (Rahman, 1998: 595; Sagafi-Nejad et al., 2008: 42–43; Hamdani and Ruffing, 2015). The ECOSOC resolution stated, “The international community has yet to formulate a positive policy and establish effective machinery for dealing with the issues raised by the activities of these corporations” (ECOSOC, 1972: 3). Hence, ECOSOC decided to appoint the 20-member Group of Eminent Persons (GEP) in 1972. The group included nine members from the public sector, six from academe, and five from public and private enterprises and on a broad geographical basis (Sagafi-Nejad et al., 2008: 57). The group was assigned to study the role of multinational corporations and their impact on the process of development (ECOSOC, 1972: 4). This marked the beginning of the other strand of the UN work on anti-tax avoidance initiatives.

The GEP finished its report in 1974 and recommended, among other things, that a Commission for Transnational Corporations and an Information and Research Centre on Transnational Corporations be established under ECOSOC (Rahman, 1998: 599; Hamdani and Ruffing,

2015).[5] A year after the GEP report, in 1975, the UNCTC was formed as an autonomous centre of the UN Secretariat in New York, where it operated until 1993 (Sagafi-Nejad et al., 2008: 6; Sauvant, 2015). The UN Member States also decided to form several subgroups under the UNCTC. One of these subgroups was the UN group of accounting experts (GEISAR) that convened in 1976 (Rahman, 1998: 598).[6] It was the 1977 GEISAR report that moved the substantial accounting-related issues forward, although the group suffered from some organizational misfortunes (Yoshida, 1987: 258–259).[7] Although the UN's role in early attempts to establish international regulation of accounting has been noted in the literature on global economic governance (e.g. Nölke, 2011: 67; McSweeney, 2010: 10), these accounts have not analysed the UN's substantial contributions towards broader financial reporting (with the exceptions of Surrey, 1978a; Surrey, 1978b; and Hamdani and Ruffing, 2015). Owing to the strong emphasis on accounting issues, the GEISAR group made advances, especially in improving corporate financial transparency.

3. The UN contributions in analysing international corporate tax avoidance and its impacts

This section looks at the substantial contributions of the various UNCTC groups and reports analysing international corporate tax avoidance and evasion, highlighting some of the key insights that the UNCTC documents provide on corporate tax avoidance and its effects. After this section, I turn to analyse thematically the key policy proposals and their contemporary significance. Generally, it can be said that the early UNCTC reports portrayed a surprisingly clairvoyant and even far-sighted analysis of the key loopholes in international corporate tax governance. This was especially valuable as the theme was severely underresearched at the time, which made the work of the rapporteurs highly challenging.

[5] In 1973, the UN Department of Economic and Social Affairs prepared a background report, Multinational Corporations in Development, for the GEP. Many of the recommendations and analyses of the GEP drew heavily from this 1973 report (Sagafi-Nejad et al., 2008: 59).

[6] In addition, a Working Group on the Code of Conduct was created under the UNCTC (Sauvant, 2015: 20).

[7] Yoshida notes how the first report was not formally adopted because members of the Group were not government representatives of their respective countries.

The GEP made several important contributions. In its 1974 report, it noted how "advances in communications technology allow many multinational corporations to pursue global strategies which, rather than maximizing the profits or growth of individual affiliates, seek to advance the interest of the enterprise as a whole" (UN, 1974: 30). These profit maximization strategies were helped by a "lack of harmonization of policies among countries, in monetary or tax fields for example", which allows transnationally mobile multinational corporations to "circumvent national policies or render them ineffective" (UN, 1974: 30). This circumvention is usually conducted "by corporate planning mechanisms situated in a few industrial countries" (UN, 1974: 30), resulting in a situation where "the 'invisible hand' of the market is far from the only force guiding economic decisions" (UN, 1974: 41).

Furthermore, the GEP report stated that corporations could engage in price discrimination and (abusive) transfer pricing, among other market-distorting acts[8] (UN, 1974: 30). The report argued that "a policy framework which may be adequate for dealing with national corporations needs to be modified when dealing with multinational ones" (UN, 1974: 31), since national attempts to raise taxes "can be negated by vertically or horizontally integrated multinational corporations through transfer pricing and the use of tax havens" (UN, 1974: 35). This analysis on transfer pricing and tax havens was surprisingly mature, given that it was formulated in the mid-1970s. Although the GEP report identified some policy demands, its major policy contribution was to pave the way for further UN work on TNCs. In addition, it is worth noting that the report demanded larger taxing rights and help in tax-related capacity building for developing countries. And remarkably, both of these demands have been emerging issues in the financing for development discussions in the current millennium.

The 1974 GEP report was not the first UNCTC publication to highlight the significance of transfer pricing-related tax avoidance. A year earlier, the Multinational Corporations in World Development report addressed this issue at length. The report noted that the "large incidence of inter-affiliate transactions and attendant transfer pricing can distort the real picture, as can other practices involving

[8] It should be noted that transfer pricing is a necessary feature of intracompany trade in any corporation. Transfer pricing can facilitate tax avoidance when the prices used in the intrafirm price are being distorted.

capitalization, accounting procedures, and control of local resources", and that this distortion takes place by charging prices for imports that are "far above prevailing 'world' prices, and [that] conversely those for exports have been below world prices" (UN, 1973: 32). The UNCTC also noted that many goods and service trades within firms do *not* involve arm's length transactions. Hence, "their prices are not determined by the market mechanism but by the corporations themselves" (UN, 1973: 33). This resonates with the contemporary research on this issue (e.g. Avi-Yonah, 2004: 499, 1995; Eden, 2016; Ylönen and Teivainen, 2015).

Moreover, in response to a request by the UNCTAD Secretary-General, the 1972 report of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries dedicated a chapter to addressing tax avoidance and evasion. These topics were addressed frequently in subsequent reports as well. The 1972 report noted the difficulties that developing countries face in auditing intrafirm transfer prices. In addition, the report noted how "international tax evasion was viewed as a serious problem by developing countries substantially engaged in world commerce" (UN, 1972: 54). Representatives of developing countries highlighted the problems created by tax avoidance, especially in relation to dividends and loans, as well as through "the use of favourable legal forms, tax havens, abuse of certain tax incentives, and tax treaties as vehicles for tax avoidance" (UN, 1972: 54). Finally, the 1979 Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries summarized much of the work of earlier reports (UN, 1979). As with many other UN publications on these themes, however, its substantial inputs were later forgotten.

The UN's insights on corporate tax avoidance were not limited to the issue of transfer pricing. As an example, the 1976 UNCTC report that viewed corporate accounting and reporting issues from the developing country perspective drew attention to the problems of thin capitalization. The report noted that there are cases in which "capital expenditures by subsidiaries are financed by the parent company by means of loans at relatively high rates of interest rather than by an increase in the subsidiary's equity" (UN, 1976: 4; see also Surrey, 1978b). Moreover, dividends and royalty payments can be used to withdraw profits from subsidiaries and by a careful utilization of holding companies (UN, 1973, 32; see also Surrey, 1978a: 32–41). In other words, the publications presented a fairly concise and detailed

picture of tax avoidance practices, even though the information was scattered among several reports.

What is more, the UN reports offered a sophisticated analysis of the role of royalties in international tax avoidance. The 1973 report on the role of MNCs in world development noted how estimates of royalties can distort the true payments for know-how in various ways. In particular, the "distortion may take the form of overpricing of intermediate products and capital goods, which are tied to the imports of technology, or the underpricing of exports to the suppliers of the technical know-how" (UN, 1973: 50). As a consequence, changes in royalty payments may not reflect changes in real prices but simply "a readjustment in the distribution of returns among the different channels of income remission" (UN, 1973: 50). A UNCTC report published a year later stressed the importance of arbitrary pricing of services, patents or techniques of know-how in intrafirm trade (Shoup, 1974: 8). The 1976 report touched upon this same theme by noting how the key question in the pricing of overhead expenses is not one of pricing but of where the profits are the allocated – and that this allocation is often not fair (UN, 1976: 4).

4. The UN proposals for reforming the international tax system: A contemporary angle

This section looks at the substantial policy proposals made by the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, the UNCTC, and its subgroups. The UNCTC's work on accounting standards and the Code of Conduct on Transnational Corporations have already gathered scholarly attention (Hamdani and Ruffing, 2015); however, my approach differs markedly from earlier accounts. Specifically, I look at the UN's and the UNCTC's policy contributions in light of contemporary discussions on tackling international tax avoidance, especially in the context of the OECD's 1998 *Harmful Tax Competition* initiative and the BEPS process. I begin with what seems to be one of the most obvious contributions, namely the work on exchange of information. After this, I continue by discussing the UN work on accounting standards. Here I highlight the so-far neglected aspect of GEISAR's work, namely the proposals for increased country-level and segmented reporting that arose alongside similar developments in academia. Third, I highlight the UNCTC's discussions

on another contemporary, highly relevant initiative – unitary taxation. Finally, I cover some other initiatives that were mentioned in the UNCTC's publications, such as the proposal for the International Tax Court and greater regional tax cooperation, an initiative that is currently being debated, for example, in the African Tax Administrators Forum.

Already in 1969, the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries had noted how developing countries may not benefit from the tax information exchange agreements (UN, 1969: 19). This led the Group to demand stronger wording on the exchange of information than in the OECD's approach, with a special emphasis on preventing fraud and tax evasion, and stress on the affirmative obligation of competent authorities to fully implement the exchange of information (Surrey, 1978a: 4). In 1971, the issue of automatic exchange of information was brought up in the Group, as well as the obstacles created by banking secrecy laws and the use of holding companies. Specifically, the Group noted how "exchanges of information between tax administrations through the application of tax agreements, could not be regarded as a very effective method of putting an end to the flight of capital, and more comprehensive international co-operation was therefore required in that field" (UN, 1970: 19). A year later, multilateral exchange of information was highlighted as a possible solution to these problems (UN, 1972: 55), although the Group report published six years later found this idea to be "premature" (UN, 1978: 59). Nearly four decades later, multilateral exchange of information has finally made a breakthrough in global governance, with several recent initiatives put forward by the OECD, the European Union (EU) and the G20.

Building on the aforementioned analyses in the 1974 Report of the Eminent Persons, the GEISAR group was the main forum at which the UNCTC developed its inputs for international accounting regulation. The first GEISAR report noted that traditional annual reports are oriented to the information needs of shareholders and creditors and that there is a need for broader, improved, and more harmonized corporate reporting (UN, 1977: 2). The report also made a detailed proposal for the items that should be furnished in the future accounting standards. The proposal included a section on Financial information on members of a transnational corporation group (UN, 1977: 20) and another section on Reporting on segments of a transnational corporation (UN, 1977: 21).

The following information was proposed for reporting under the first category (UN, 1977, Annex p. 8):

1. List of significant subsidiaries and percentage ownership (by geographical area of operation), justify exclusion of any such subsidiaries from consolidation. Carry excluded subsidiaries at equity or disclose equity in the footnotes.

2. List of associated companies and nature of relationship with parent company (by geographical area of operation). Justify carrying such investments at other than equity and disclose equity in the footnotes.

3. Disclosure of identity of parent company in reports of subsidiaries.

4. Disclosure of information on the following (eliminated in consolidated statements)

(a) Intercompany sales

(b) Intercompany charges for interest, royalties, license fees, rental for use of tangible property and other intangibles

(c) Intercompany charges for research and development, advertising, management services and other allocated expenses

(d) Net increase (decrease) in intercompany investments

(e) Net increase (decrease) in intercompany loans

In addition, the GEISAR report demanded segmented reporting for assets or net assets, revenues, earnings, exposure to exceptional risks, principal activities in each area, new capital investments, identifiable assets by industries, other assets, revenue and sales by industries, and one or more of the following: profit contribution, operating profit, profit before taxes and net profit. Effectively, these measures would have resulted in a significant broadening of the corporate reporting requirements.

Similar issues were also discussed in the OECD, but with less ambitious formulations. The 1976 OECD Guidelines for Multinational Enterprises stated that companies should publish annually the structure

of the enterprise, the geographical areas where the company operates, sales by geographic area and by major lines of business, significant new capital investments, the sources and uses of funds of the company as a whole, the average number of employees and the R&D expenditures in each geographical area, the policies followed for intragroup pricing and the accounting policies (Surrey, 1978b: 434–435). Interestingly, the OECD's 1976 Guidelines also stated that companies should "refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm's length standard" (Surrey, 1978b: 437).[9]

The OECD's early contribution to the tax and corporate responsibility discussions is a notable opening, especially as this theme has started to attract scholarly attention only in recent years (Hasseldine and Morris, 2013; Sikka, 2010; Sikka, 2013; Ylönen and Laine, 2015). However, in contrast to the UN's guidelines, the OECD's contributions were designed to remain voluntary. Although there was a consensus that the UN's Code of Conduct was to be not compulsory in character by that time either, the GEP believed that the authority of the international organizations and the pressure from the public would help to realize their aims (UN, 1974b: 55). In addition, the long-term goal was to come up with a "general agreement on multinational corporations having a force of an international treaty and containing provisions for machinery and sanctions" (Hamdani and Ruffing, 2015: 80). The work of the GEISAR group continued in several subsequent reports. In the 1980 interim report, the group noted,

> Transnational corporations should make available to the public in the countries in which they operate clear, full and comprehensible information designed to improve understanding of the structure, activities, and policies of the transnational corporation as a whole. The information should include financial as well as non-financial items and should be made available on a regular annual basis … information provided for the transnational corporation as a whole should be broken down by geographical

[9] In the 2000 update of the OECD's Guidelines, this point had been modified to suggest that companies should comply with the tax laws and regulations by conforming transfer pricing practices to the arm's length principle (OECD, 2001: 135). The same formulation is repeated in the most recent 2011 version of the OECD's guidelines (OECD, 2011).

area or country, as appropriate, with regard to activities of its entities, sales, operating results and significant new investment; and by major line of business. (UN, 1980, Annex III)

Finally, the GEISAR reports contributed to the draft versions of the CoC, and drafting the CoC was the established highest-priority task of the UNCTC. They were submitted to the UNCTC at its eighth session in 1982. The negotiations were entrusted to a special session of the Commission that began deliberations in 1983 and was open to the participation of all Member States (UN, 1983). The 1983 draft noted that "transnational corporations shall/should carry on their activities in conformity with the development policies, objectives and priorities set out by the Governments of the countries in which they operate" (para 9). Moreover, the draft CoC also had subsections dedicated to transfer pricing and corporate taxation. On the latter issue, the document stated that corporations should/shall not "use their corporate structure and modes of operation, such as the use of intra-corporate pricing which is not based on the arm's length principle, or other means, to modify the tax base on which their entities are assessed" (para 34). Finally, the draft document also noted that "in respect of their intra-corporate transactions, transnational corporations, should/shall not use pricing policies that are not based on relevant market prices, or, in the absence of such prices, the arm's length principle, which have the effect of modifying the tax base on which their entities are assessed or of evading exchange control measures [or customs valuation regulations] [or which [contrary to national laws and regulations] adversely affect economic and social conditions] of the countries in which they operate" (UN, 1983, para 33, brackets in the original negotiation's draft text).

These words ended up being the most important demands of the UN machinery for tackling corporate tax flight. Then the atmosphere changed. As a symptom of this, GEISAR switched to a more cautious tone in its analysis in 1984, and its mission was significantly narrowed. Instead of pursuing the development of new accounting standards, the group's mandate changed "to review material from international accountancy bodies and other interested groups" (UN, 1984: 3). According to Rahman (1998), this reflected the increased prominence of the self-regulatory IASC as the main body for discussions on regulation of international accounting. In addition, the group "considered it necessary to take account of the need of transnational corporations to

maintain business confidentiality in sensitive areas, in particular so as not to jeopardize their competitive position" (UN, 1984: 5). The goal was then revised; international harmonization was now the long-term objective (UN, 1984: 5). As Hamdani and Ruffing (2015: 80) note, the "proponents overreached for a general agreement and failed in their primary task to complete a code of conduct".

The new rhetoric resonated well with the concerns that some delegations already had with the first GEISAR report, which they called "overly ambitious" (UN, 1984: 5). The ambition level was significantly reduced as a distinction was made between general purpose and special purpose reporting. Public disclosure of special purpose reporting might be permitted only by mutual agreement instead of mandatory requirement (UN, 1984: 5). Finally, in 1988, the UN released its conclusions on accounting and reporting by TNCs (UN, 1988). Although the conclusions still included many of the ideas from the first GEISAR report, it became clear that the UN had been sidelined in the discussions on international accounting regulation (Hamdani and Ruffing 2015: 18). The group was ultimately unable to ratify an agreeable code owing to various disagreements between developed and developing countries, and the group was finally dissolved in 1994, after the abolition of the UNCTC in 1992 (Deva, 2012; Hamdani and Ruffing, 2015). Chapter X of the 1993 *World Investment Report* (UN 1993) ended up being one of the last manifestations of the old UN paradigm, in regard to its analyses of the possibilities of unitary taxation and the use of advance pricing agreements for fixing the underlying problems of the arm's length principle.[10] Eventually, public pressures led the UN to re-establish its work on TNCs in the late 1990s, but this time in the much less controversial context of business and human rights.

[10] Most of the other *World Investment Reports* published during the 1990s and 2000s analysed the growth and development of bilateral tax treaties, occasionally also discussing issues related to e.g. tax havens and intrafirm tax avoidance. Illustratively, in 2000, the report noted how "Concern about transfer pricing, greatest in the 1960s and 1970s, has declined as tax differences have narrowed, double-taxation agreements have proliferated and the desire to attract FDI has become widespread" (UN, 2000: 165). The *World Investment Report 2005* was the first not to explicitly mention the UNCTC in its foreword note, referring instead to the UN's 30 years of experience in these areas (UN, 2005: ii). Recently, interest in these themes has regenerated; e.g. the 2015 *World Investment Report* included a chapter dedicated to international tax and investment policy coherence (UN, 2015).

The initiatives originally put forward by GEISAR and some academics (especially Ralph Nader, Mark Green and Joseph Seligman, who explicitly discussed country-by-country reporting in the 1970s[11]) bore great resemblance to the country-by-country reporting initiatives (Murphy, 2007; Murphy, 2009) that have been developed in the current millennium. Both strands of initiatives call for similar extensions in corporate transparency and share an analysis of the problems created by the lack of disclosure. Moreover, they proposed similar measures for addressing these problems. Recently, the extended country-by-country reporting requirements for TNCs have been praised as the single most important outcome of the BEPS project – even though the reports will be accessible only for authorities and the new system will not be accompanied by an effective exchange of information on the reports (BEPS Monitoring Group, 2015).

Unitary taxation is another major corporate tax-related initiative that has been discussed for a long time, recently for example in the EU. Basically, unitary taxation presents a competing principle to the prevailing arm's length principle in the regulation of intracompany trade. In contrast to the arm's length principle, which treats subsidiaries of a TNC as separate entities, unitary taxation taxes companies as a single entity, with tax revenues distributed to states by a commonly agreed formula (Eden, 2007: 612; see also Avi-Yonah, 2016). This kind of system is used in the United States for allocating tax revenues between the individual states. The EU had already presented a first draft for its so-called Common Consolidated Corporate Tax Base (CCCTB) in 2011 (European Commission, 2011), and in June 2015 the European Commission included the CCCTB as a central goal in its five-point action plan on corporate taxation (European Commission, 2015).

The EU was not the first organization by far to discuss unitary taxation. Indeed, the initiative was brought up in the negotiations of the League of Nations, but it was found too politically difficult to adopt. The discussions in the UNCTC should also be highlighted. For example, the UNCTC's 1974 technical paper on taxation noted how

[11] Specifically, Nader et al. (1977) maintained that trade secrecy had become an all-purpose excuse for declining an information request, even though the actual trade secrecy privilege is quite narrow (p. 138). Moreover, they suggested that statements should be broken down on a 'U.S.' and 'all foreign' basis, and that there should be foreign financial reports furnished on a country-by-country basis (p. 176).

“a radical change in the taxation of multinational corporation profits would be the adoption of a factor-formula technique” (Shoup, 1974: 33). Another contributor of this publication also noted how an “implicit justification for formula apportionment is essentially that profits should be apportioned among the states in proportion to the contribution to the value added” (McLure Jr., 1974: 69).

Unitary taxation was also discussed in the 1974 Report of the Eminent Persons. Noting the existing unitary taxation practice in the United States, the report suggested that an agreed pro rata formula would be an ambitious approach to tax TNCs (p. 93). Moreover, the authors of the report noted that taxing the worldwide profits on an accrual basis would help in tackling tax havens. The report even discussed the possibility of denying the right of establishment in countries that would not adhere to the unitary system (UN, 1974: 93). Although unitary taxation never found its way into the policy proposals of GEISAR and the discussion in the GEP report was also non-confirmative, it is clear that the major UNCTC bodies understood the potential of the initiative (UN 1974, pp. 93–94) .

Finally, the UNCTC publications covered some lesser-known initiatives that have been rediscovered in the past years. As a one significant example, the 1974 Report of Eminent Persons called the governments to “disclose the principal terms of agreements between them and multinational corporations” (p. 96), a call that has been raised several times after the LuxLeaks scandal, which involved some 30,000 tax-related pricing agreements that the government of Luxembourg had conducted with multinational companies. Moreover, recent years have seen several calls and attempts for increased South-South cooperation in international tax matters. The need for and potential benefits of this kind of cooperation had already been noticed in the 1974 Report of the Eminent Persons (UN, 1974). Finally, the 1974 technical paper on taxation also discussed the possibility of “setting up an international tax court…to obviate intercountry inconsistencies in transfer pricing” (Shoup, 1974: 32), resembling discussions on an independent dispute-settlement body or arbitration mechanism in recent proposals for a new international tax authority (Rixen, 2016; Tanzi, 2016). The list could be continued.

All in all, the tax initiatives that the UNCTC advocated either directly through its conduct or more indecisively in its reports have proven to be surprisingly relevant even today. The automatic exchange of tax information has progressed quickly in the post-financial crisis era. The country-specific and sector-specific financial reporting for corporations was extended first in the early 2000s with voluntary initiatives in the extractive industries, and then with mandatory legislation in the financial sector and extractive industries. Moreover, the OECD's BEPS process introduced mandatory country-by-country reporting for TNCs in all sectors, even though this information will not be public and therefore it remains to be seen how well the information exchange between countries on this information will work. Many of the other overall concerns discussed in the UNCTC remain also highly relevant.

5. Looking back: why were the UNCTC's proposals forgotten?

In recent decades, the constructivist turn in international relations and other social sciences has drawn much attention to the role of ideas in shaping politics on all levels. Robert Cox (1983, 1986), Keck and Sikkink (1999), and many others scholars have made a strong case that policy experts, the transnational classes that they form and the ideas they convey have a much bigger impact on world politics than had been commonly understood earlier. The collective amnesia about the UN's early work in the field of international corporate taxation is a prime example of this. The oblivion of the proposals that the UN (and to a lesser extent the OECD) advocated for between 1960s and 1980s not only made rediscovering many of these initiatives a painful and prolonged process, but also facilitated the emergence of alternative conceptual frameworks for understanding the role of large corporations in the society. The OECD-driven late-1990s tax community (Haas, 1992) failed to pay attention to the earlier work of the UN, which paved the way for the OECD's triumphant re-entry in this field in the late 1990s.

The 1990s saw the parallel emergence of the corporate social responsibility agenda and the OECD's work on tax havens. These initiatives represented a comeback of calls for better regulation and transparency of TNCs, but in a form that had little in common with the earlier UN efforts. The UN had restarted its own work on corporations,

as the Sub-Commission on the Promotion and Protection of Human Rights founded a Working Group on Transnational Corporations in 1998. Three years later, the Group completed the final draft of the Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights, which served as a basis for the United Nations Guiding Principles on Business and Human Rights. Commonly known as the Ruggie principles, their approach to TNCs was based on the concept of corporate responsibilities, which resonated well with the rising corporate social responsibility agenda of the time. Importantly, many of the civil society organizations criticizing the dominant world powers also embraced the human rights and anti-corruption agendas. In the early 2000s, the multi-stakeholder Extractive Industry Transparency Initiative gathered much attention with its rather modest anti-corruption aim of demanding greater voluntary transparency regarding payments to governments. A few years before this, a group of non-governmental organizations formed the Publish What You Pay initiative with a similar agenda (Seabrooke and Wigan, 2015). The norms of the time had become so widely shared that they were internalized by actors and achieved a taken for granted quality and conformity, which is a powerful building block for ideational power (Finnemore and Sikkink, 1998: 904).

Earlier I noted how the OECD's landmark report *Harmful Tax Practices: An Emerging Global Issue* (OECD, 1998) failed to cite any reference published before the early 1980s. In subsequent years, several scholars started to analyse the initiative (e.g. Dietsch, 2016; Meinzer, 2016; Sharman, 2006), but mostly from a contemporary angle. By the late 1990s the earlier UN agenda had been discarded on all fronts. In the field of accounting regulation, the IASC was formed in 1973 and the OECD geared up its work on accounting and international taxation (see below). Even though it has been argued that until the 1980s, the IASC "remained an obscure body with little impact on international accounting" (Martinez-Dias, 2005: 1), it seems plausible that its foundation strengthened the calls to scale down the accounting-related work of GEISAR and the UNCTC (Hamdani and Ruffing 2015: 133–136). As mentioned earlier, in 1984 the GEISAR group's mandate was reduced "to review material from international accountancy bodies and other interested groups" (UN, 1984: 3). At that time, the IASC was the only other international accountancy body. Thus, the IASC's importance has been larger than sometimes perceived right from its beginnings.

This development is a prime example of forum shifting, which refers to a tendency of prevailing superpowers to shift discussions from one forum to another to avoid resistance and losses in forums that they do not adequately control (Braithwaite and Drahos, 2000: 28–29).

After the creation of the IASC, there was no room left for genuinely influential policy work for the UNCTC, as the major players in international politics backed the IASC. In a way, the UN became a victim of its own success, as its major progress was achieved in the field of accounting regulation. Little was left after the mandate to work on accounting issues was taken away from the UN. The IASC's successor, the International Accounting Standards Board (IASB), has been at least as disinclined to initiatives that would enhance corporate financial transparency as the IASC was (Lesage and Kaçar, 2013). Contrary to the situation in the 1970s and 1980s, however, one self-regulatory organization can no longer dominate the discussions on international accounting regulation, not even with a mandate that greatly exceeds that of the IASC. At the same time, the mainstream of academic studies on corporations shifted from analyses of power to more apolitical theories arising from transaction costs theory and conducted within econometric methods. After all, many of the UNCTC's analyses were either drafted by prominent academic researchers of the time or heavily influenced by them. Consequently, as the international policy community rediscovered the powers exerted by TNCs in the late 1990s, neither analytical tools nor policy networks were available for analysing them.

Moreover, the OECD also geared up its work on international tax issues in tandem with the forum shift from the UN to the IASC. In 1975, the OECD established the Committee on International Investment and Multinational Enterprises, "almost certainly in response to the adversarial attitude of many countries to TNC activities" (Sagafi-Nejad et al., 2008: 111). One of the tasks of this committee was to elaborate its own set of guidelines – adopted in June 1975 – a move that was at least partly targeted against the UN process of 1976 (Hamdani and Ruffing, 2015: 83). Moreover, the International Labour Organization also started a similar initiative for creating its own guidelines for TNCs (Tapiola, 2015: 110). And as the pressure coming from the UNCTC faded, the OECD's earlier views on including transfer-pricing issues in the scope of corporate code of conduct were also forgotten.

In addition, the conclusion of bilateral tax treaties for the elimination of double taxation emerged from the 1960s onward as a salient feature of inter-State relations (UN, 2003: 3; see also Hearson, 2015). Earlier I noted that the OECD published its first draft model treaty for bilateral treaties in 1963 and that finally the OECD Model Double Tax Convention on Income and on Capital was published in 1977 (UN, 2003: 3). The rules for dividing corporate tax incomes between states were thus developed in the same period that the UN was discussing the rules for financial disclosure of these activities, thus downplaying the UN activities. Even though the OECD had recognized some of the developing-country concerns as early as in 1965, the OECD's solutions were clearly more favourable to the developed countries. Altogether, these factors helped the OECD to secure its leading position in what has been called the international tax regime (Eden, 2007: 598).

Last but definitely not least, several developments in the global political economy favoured the demise of the UN and the UNCTC and the shift to less ambitious forums. Sagafi-Nejad et al. (2008: 119) noted that by "the mid-1980s, many developing countries were in the throes of structural adjustment policies to cope with deficits in their balance of payments, the aftermath of recession, and the huge debts that arose from the energy crises of 1973-1974 and 1979-1980" (see also Hamdani and Ruffing, 2015: 18). Consequently, developing countries were desperate for capital and technology. This led many countries to revise their attitudes toward TNCs, either voluntarily or forced by the structural adjustment programs. The UNCTC was dissolved in 1993, with its remaining functions integrated into UNCTAD. Sagafi-Nejad et al. (2008: 29) described how "nation-states became friendlier towards FDI, competing over who would give more generous incentives to attract companies". Consequently, the focus of the UN shifted. The emphasis on a code of conduct, not to speak of a more binding version of it in the future, which were the key goals of the UNCTC, were de-prioritized and eventually faded into oblivion.

After the UNCTC was dismantled, UNCTAD occasionally touched upon tax and accounting issues in some of its seminars, mostly from the perspective of capacity building for developing countries (Sagafi-Nejad *et al.*, 2008: 137). Although the UNCTC's work on accounting continued to receive some coverage (e.g. Cobham and McNair, 2012: 44), the early UNCTC proposals were largely forgotten. In addition,

the poorly resourced UN Tax Committee has never managed to become a serious competitor to the OECD, despite the interest by civil society in stepping up its resources and mandate in the 2000s. In this millennium, civil society organizations such as the Tax Justice Network and Global Financial Integrity have had a central role in promoting initiatives such as automatic exchange of information and country-by-country reporting. However, generally they seem to have had a more contemporary orientation to these issues (Seabrooke, 2014: 50). In this decade, however, tax-related themes have made a real breakthrough onto the international policy agenda in UN and other forums (e.g., UN 2015).

The experience of the UN and the OECD in tackling international corporate tax avoidance highlights the interlinkages between so-called epistemic communities that include the key policymakers in one policy area, and their collective memory. Langenbacher (2010: 33) has noted how power stems from the degree of dominance that a memory achieves in a political culture and the importance of how many memories circulate, how widely a specific memory is held and how deep the attachment is.[12] In the late 1990s, the memories circulating about the earlier UN work were few and far between. The backgrounds and shared knowledge of the emergent entrepreneurs (Seabrooke and Wigan, 2013) who have recently promoted these issues in civil society and international organizations differed markedly from that of the specialists whose knowledge the UN had employed in the 1970s. However, it would be misguided to see this shift as necessarily a negative thing. Although the collective oblivion helped the OECD to gather publicity for its 1998 Harmful Tax Competition report and its newborn role in this field, it may have also helped critics of the OECD to attach a sense of novelty to policy ideas that went beyond those advocated by the OECD.

In summary, the project for regulating corporate planning and bring more transparency to it in the 1970s was institutionally conducted in a winner-takes-all situation. The UN made major headway with the work conducted in the Ad Hoc Group, the UNCTC and its GEISAR group,

[12] Langenbacher and Shain have also noted how the international policy impact of collective memory has not received the systematic attention in either the academy or the policy arena that it deserves (2010: 1). It is easy to agree with this statement in light of the case studies put forward in this article.

but its influence faded as the balance of power shifted in favour of the IASC and the OECD. These developments were accentuated by the lack of additional forces (civil society, media, and other international organizations) that would have been able to sustain the pressure. Recalling how the transnational legal order on international corporate taxation developed in the 1920s as an expert-driven process with only a limited global political interest (Genschel and Rixen, 2014), it can be seen that the 1970s permitted the birth of a similar exercise in the epistemic community (Braithwaite and Drahos, 2000; Haas, 1992) of corporate tax avoidance experts. However, compared with the 1920s, this consolidation period was a short one, as the OECD and other competing organizations started to challenge the UN position. This is an important reminder that even if the emergent entrepreneurs manage to seize the moment with ideas well suited to the political moods of the time, a sudden shift in the international balance of power can quickly derail such attempts.

In comparison, today's emergent entrepreneurs benefit from the fact that the current international political situation is much more diverse with regard to both ideas and institutions. This enables civil society organizations, international organizations, politicians and even investors to gain small but repeated political victories in pushing initiatives against tax avoidance and tax havens despite powerful resistance from the IASB and elsewhere. The disempowering and consequent dismantling of the UNCTC and parts of the other UN work resulted in the destruction of a policy community – or epistemic community – that could have maintained and spread knowledge of the ways to open up corporate accounts (Braithwaite and Drahos, 2000: 29). The epistemic community of accounting companies was strengthened instead.

The example of the development of broader disclosure requirements in the UNCTC and the calls for other ways to tackle tax flight and tax havens show how difficult it is to create a lasting political initiative when its success depends on the political will and resources of a single international organization under constant threat of losing its legitimacy in the eyes of the prevailing powers. The results of the UNCTC's loss of legitimacy and power, coupled with the ideological turn of the late 1970s and the U.S. Senate's loss of interest in researching the political power of the corporation were so devastating that the

substantial inputs proposed by the UNCTC and the scholars of that time seem to have been forgotten by academe, policymakers, and civil society. In contrast, compared with the 1970s, there is a much broader consensus today between northern and southern countries on the issues and problems at stake. Therefore, playing down the proposed initiatives is and likely will be more difficult for their opponents than in the earlier decades.

Despite their eventual failure, the early UN proposals were surprisingly clairvoyant in their analysis of the problem at hand and the policy measures the UN proposed. One key reason for this was probably that the UNCTC put great effort into recruiting the best-skilled people available for drafting the substantial material. Many of these people were from academia and were hired on a consultancy basis, in case they were unwilling to sign a longer contract or the UNCTC was unable to afford them (interview with Klaus Sahlgren). This situation can be contrasted with the corporate transparency initiatives developed from the beginning of the 1990s onward. A big difference between these two historical waves in calls for corporate transparency was in their underlying analysis of corporate power. The early proposals for corporate financial transparency saw the corporate planning as a major problem for the functioning of markets and well-functioning state governance. In contrast, the 1990s calls for corporate transparency were framed more in the context of corporate social responsibility and tackling of corruption. In this sense, they were partly products of the anti-state tenets of the 1980s that played a role in the abandonment of the earlier initiatives.

6. Final words

In August 2015, policymakers, civil society, and UN personnel from around the world gathered in Addis Ababa, Ethiopia, for the Third International Conference on Financing for Development. Preceded by the high-profile Monterrey conference in 2002 and the follow-up conference in Doha in 2008, the Addis Ababa event sought to renew international commitments for development financing in a difficult global political environment. One of the key goals of civil society representatives was to strengthen and upgrade the UN Tax Committee. However, the calls for more inclusive global governance of tax issues were not answered. In a way, history is repeating itself. The urge to

reverse the forum shift that the IASC and the OECD managed in the 1970s is there, but the opposing forces have been too strong, at least for the time being.

A better understanding of the history of international tax governance may help in formulating better strategies and substantial arguments. This article has contributed to the political economy literature on corporate transparency and power in six respects. First, it provided new information on and analysis of the early history of the anti-tax avoidance and evasion initiatives, thus contributing to and in parts challenging some earlier accounts on this topic: as examples, I showed how the histories of the automatic exchange of information and country-by-country reporting initiatives – both key topics in the recent tax policy agenda – are longer than has been thought. Second, it demonstrated how the early UN publications discussed also other issues of contemporary relevance, such as South-South tax cooperation. Third, it hinted that we should look further back to understand also the emergence of the IASC, whose early significance may not have been sufficiently understood. Fourth, it highlighted that amidst the pressure from the UN, even the OECD promoted some far-reaching stances in linking tax payment with corporate social responsibility.

Fifth, the article suggested that the 1970s analyses of corporate tax avoidance drew also from the rich academic discussions of the time on corporate planning. Sixth, it showed that the examples put forward in this article can be helpful in illustrating the role of epistemic communities, emergent entrepreneurs and the politics of memory in recent social scientific research. This last may have been one explanation for why the policy community of the time was able to develop far-sighted analyses of and policy proposals for tackling corporate tax avoidance some 30 years before the contemporary discussions on these topics began.

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WORLD INVESTMENT REPORT 2016:
INVESTOR NATIONALITY: POLICY CHALLENGES

OVERVIEW

GLOBAL INVESTMENT TRENDS

The recovery in global FDI was strong in 2015

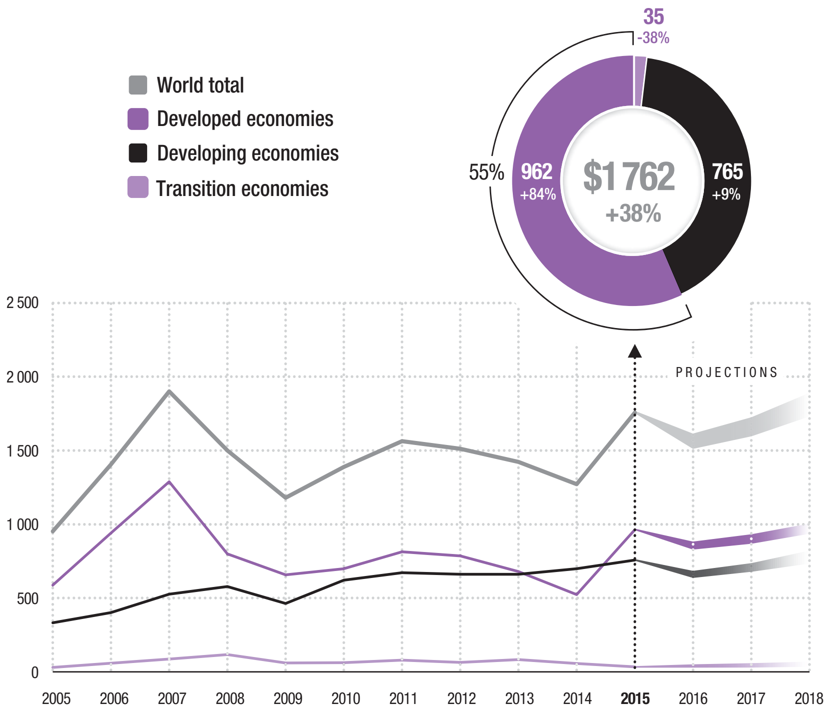
Global foreign direct investment (FDI) flows jumped by 38 per cent to $1,762 billion, their highest level since the global economic and financial crisis of 2008–2009 (figure 1). A surge in cross-border mergers and acquisitions (M&As) to $721 billion, from $432 billion in 2014, was the principal factor behind the global rebound. These acquisitions were partly driven by corporate reconfigurations, including tax inversions. Discounting these large-scale corporate reconfigurations implies a more moderate increase of about 15 per cent in global FDI flows. The value of announced greenfield investment remained at a high level, at $766 billion.

Buoyant cross-border M&As tilted FDI patterns back towards developed economies

Flows to developed economies nearly doubled (up 84 per cent) to $962 billion, up from $522 billion in 2014. Strong growth in inflows was reported in Europe. In the United States FDI almost quadrupled, albeit from a historically low level in 2014. The share of developed economies in world FDI inflows therefore leapt from 41 per cent in 2014 to 55 per cent in 2015 (figure 1), reversing a five-year trend during which developing and transition regions had become the main recipients of global FDI.

Much of this shift to developed economies was due to cross-border M&A activity, which recorded a 67 per cent increase in value to $721 billion – the highest level since 2007. Activity was particularly pronounced in the United States where net sales rose from $17 billion in 2014 to $299 billion. Deal making in Europe also rose significantly (up 36 per cent). While FDI through cross-border M&As can contribute to productive investments, a number of deals concluded in 2015 can be

Figure 1. **Global FDI inflows by group of economies, 2005–2015, and projections, 2016–2018** (Billions of dollars and per cent)

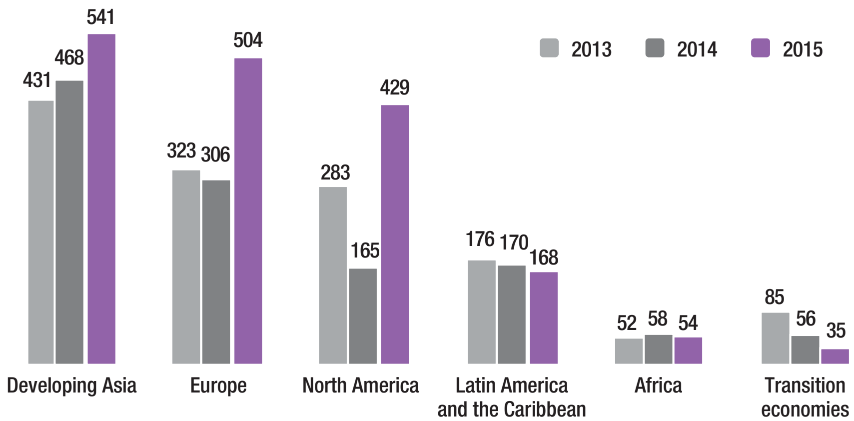


Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

attributed to corporate reconfigurations, including tax inversions. This trend was especially apparent in the United States and Europe, with several mega-deals concluded to transfer the tax domicile of an MNE to jurisdictions that offer lower corporate tax rates, and do not levy tax on global earnings.

FDI to developing economies – excluding Caribbean financial centres – increased to a new high of $765 billion (up 9 per cent). Developing Asia, with its FDI inflows surpassing half a trillion dollars remained the largest FDI recipient region in the world (figure 2). Developing economies continued to comprise half of the top 10 host economies for FDI flows (figure 3).

Figure 2. | FDI inflows, by region, 2013–2015 (Billions of dollars)



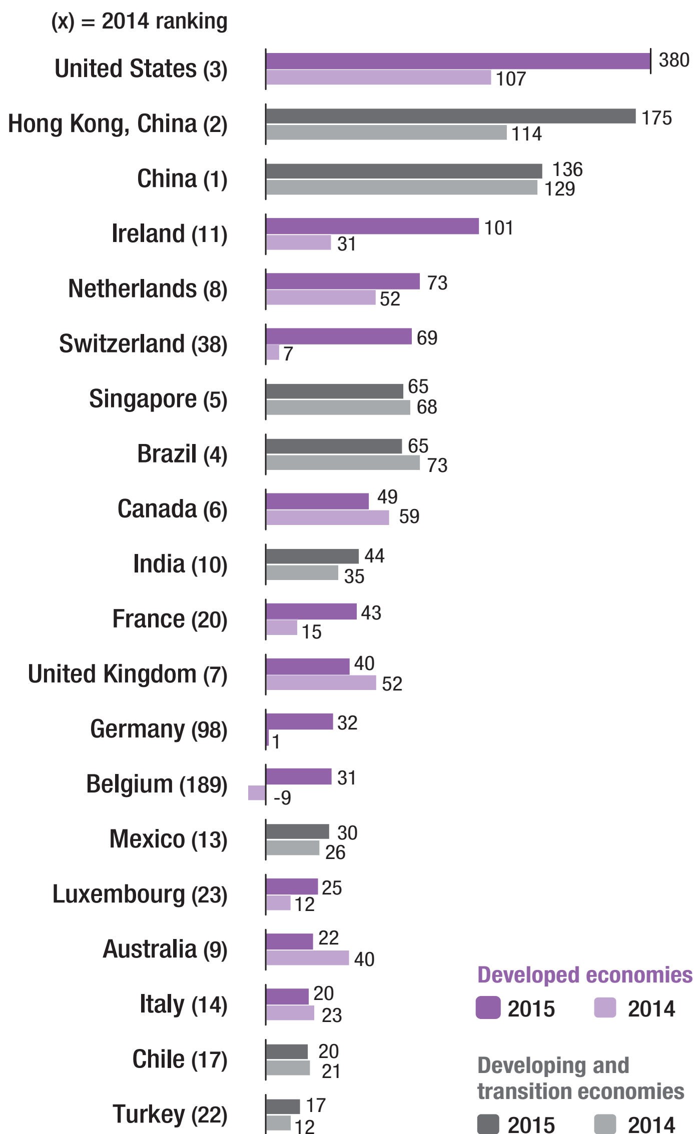
Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

Developed economies also led a rebound in FDI outflows

Following three years of decline, FDI outflows from developed economies increased by 33 per cent to $1.1 trillion. As a result, developed countries accounted for 72 per cent of global FDI outflows in 2015, up from 61 per cent in 2014. This 11 percentage point increase broke the nearly uninterrupted decline that began in 2007. The increase notwithstanding, the level of outward FDI from developed economies remained 40 per cent short of its 2007 peak. Europe became the world's largest investing region in 2015, with FDI outflows of $576 billion. Foreign investment by North American MNEs, in contrast, remained flat, with a significant gain in Canada being offset by a moderate decline in the United States. Nevertheless, the United States remains the largest investor in the world, followed by Japan (figure 4).

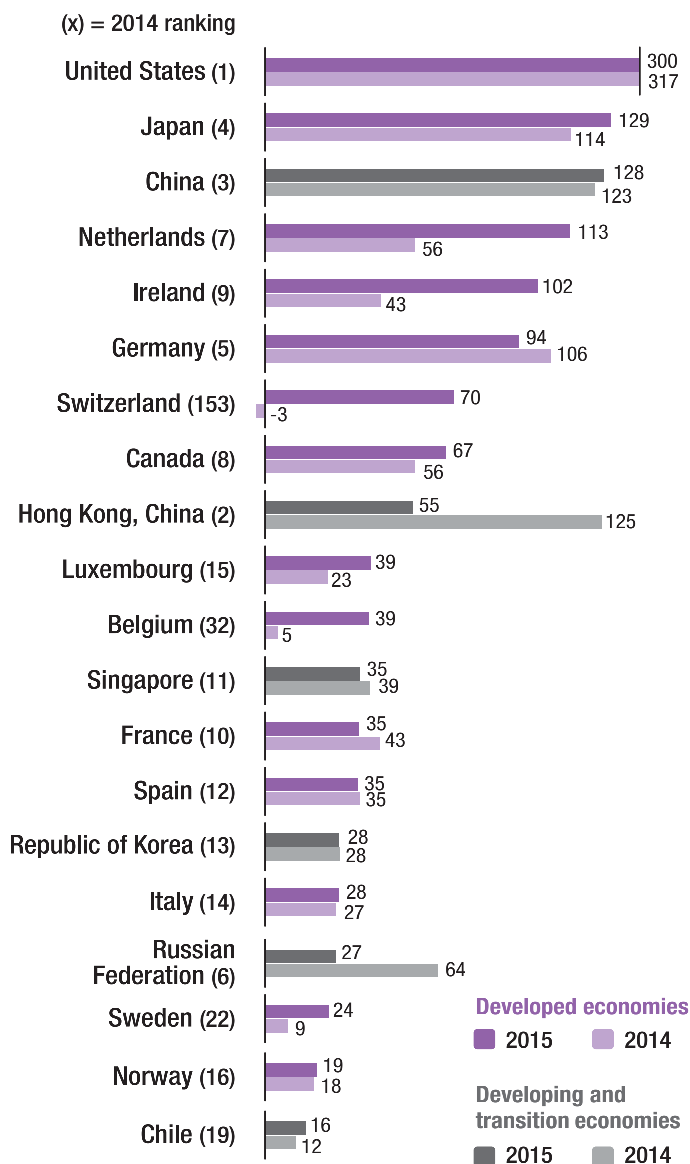
By contrast, FDI outflows declined in most developing and transition regions. A combination of challenges, including declining commodity prices and depreciating national currencies, and geopolitical risks were contributing factors. Against the general downward trend in FDI outflows from developing and transition economies, China was

Figure 3. **FDI inflows, top 20 host economies, 2014 and 2015** (Billions of dollars)



Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

Figure 4. **FDI outflows, top 20 home economies, 2014 and 2015** (Billions of dollars)



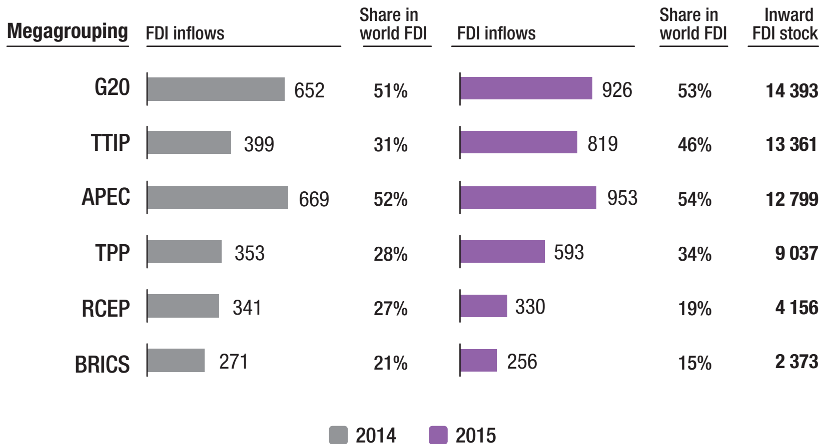
Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

a notable exception: its outward FDI remained high, rising from $123 billion to $128 billion, as a result of which it held its position as the third largest investor in the world.

Major economic groups or initiatives account for a significant share of global FDI

The G20, Transatlantic Trade and Investment Partnership, Asia-Pacific Economic Cooperation, Trans-Pacific Partnership, Regional Comprehensive Economic Partnership and the BRICS account for a significant share of global FDI flows (figure 5). With the exception of the BRICS, intra-group FDI is significant, accounting for some 30 per cent to 63 per cent of inflows in these groups. Although the actual impact on FDI patterns of these overlapping partnerships varies, a majority of MNE executives expect the emergence of mega economic groups to influence their companies' investment decisions over the next few years.

Figure 5. **FDI inflows in selected megagroupings, 2014 and 2015**
(Billions of dollars and per cent)



Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).
Note: In descending order of 2015 inward FDI stock. G20 = only the 19 member countries of the G20 (excludes the European Union); TTIP = Transatlantic Trade and Investment Partnership (under negotiation); APEC = Asia-Pacific Economic Cooperation; TPP = Trans-Pacific Partnership; RCEP = Regional Comprehensive Economic Partnership (under negotiation); BRICS = Brazil, Russian Federation, India, China and South Africa.

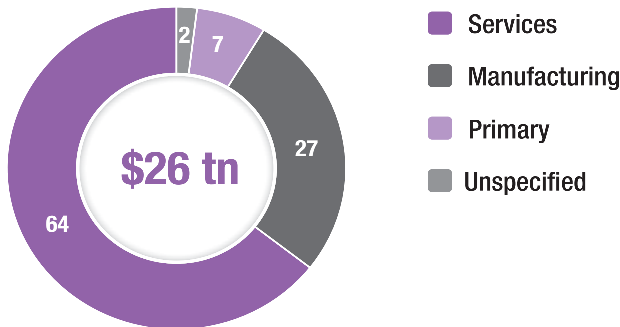
Primary sector FDI down, manufacturing up

Cross-border M&A sales in manufacturing reached a historical high in absolute terms ($388 billion in 2015), surpassing the previous record set in 2007. This raised the share of manufacturing to more than 50 per cent of cross-border M&As in 2015. FDI in the primary sector, in contrast, suffered from sluggish commodity prices, which resulted not only in reductions in planned capital expenditures but also in a sharp fall in reinvested earnings. At the global level, reduced FDI in extractive industries has affected the total amount of FDI flows, especially in developing countries. In 2014, the services sector accounted for 64 per cent of the world's total FDI stock (figure 6).

Investment flows through offshore financial hubs remain significant

Investment flows to offshore financial hubs – including those to special purpose entities (SPEs) and offshore financial centres – declined in 2015 but remain high (these flows are excluded from UNCTAD's FDI statistics).

Figure 6. Global inward FDI stock, by sector, 2014 (Trillions of dollars and per cent)



Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

The magnitude of quarterly flows through SPEs rose sharply compared with 2014, reaching the levels registered in 2012–2013. Pronounced volatility, with flows swinging from large-scale net investment in the first three quarters to drastic net divestment in the last quarter, tempered the annual total, which dipped to $221 billion. Investment flows to offshore financial centres were down to an estimated $72 billion in 2015, a retreat from their anomalous peak of $132 billion in 2013. They include growing flows from MNEs located in developing and transition economies, sometimes in the form of round-tripping and transit FDI.

The proportion of investment income booked in low tax, often offshore, jurisdictions is high despite the slowdown in offshore financial flows. The disconnect between the locations of income generation and productive investment which results in substantial fiscal losses is a key concern for policy makers.

The persistence of financial flows routed through offshore financial hubs and the potential fiscal losses due to the disconnect between income generation and productive investment underscore the pressing need to create greater coherence among tax and investment policies at the global level. The international investment and tax policy regimes are both the object of separate reform efforts. Better managing their interactions would help to make them coherent and mutually supportive. UNCTAD has proposed a set of guidelines for coherent international tax and investment policies (*WIR15*).

International production continues to expand

International production by foreign affiliates of MNEs expanded in 2015. Sales and value added rose by 7.4 per cent and 6.5 per cent, respectively. Employment of foreign affiliates reached 79.5 million (table 1). However, the return on FDI of foreign affiliates in host economies worsened, falling from 6.7 per cent in 2014 to 6.0 per cent in 2015.

Table 1.	Selected indicators of FDI and international production, 2015 and selected years

Item	Value at current prices (Billions of dollars)				
	1990	2005–2007 (pre-crisis average)	2013	2014	2015
FDI inflows	207	1 418	1 427	1 277	1 762
FDI outflows	242	1 445	1 311	1 318	1 474
FDI inward stock	2 077	14 500	24 533	25 113	24 983
FDI outward stock	2 091	15 104	24 665	24 810	25 045
Income on inward FDI	75	1 025	1 526	1 595	1 404
Rate of return on inward FDI	*4.4*	*7.3*	*6.5*	*6.7*	*6.0*
Income on outward FDI	122	1 101	1 447	1 509	1 351
Rate of return on outward FDI	*5.9*	*7.5*	*6.1*	*6.3*	*5.6*
Cross-border M&As	98	729	263	432	721
Sales of foreign affiliates	5 101	20 355	31 865	34 149	36 668
Value added (product) of foreign affiliates	1 074	4 720	7 030	7 419	7 903
Total assets of foreign affiliates	4 595	40 924	95 671	101 254	105 778
Exports of foreign affiliates	1 444	4 976	7 469	7 688	7 803
Employment by foreign affiliates (thousands)	21 454	49 565	72 239	76 821	79 505
Memorandum					
GDP	22 327	51 288	75 887	77 807	73 152
Gross fixed capital formation	5 072	11 801	18 753	19 429	18 200
Royalties and licence fee receipts	29	172	298	311	299
Exports of goods and services	4 107	15 034	23 158	23 441	20 861

Source: ©UNCTAD.

FDI flows are expected to decline by 10–15 per cent in 2016, but to pick up over the medium term

FDI flows are expected to decline in 2016 in both developed and developing economies, barring another wave of cross-border megadeals and corporate reconfigurations. UNCTAD forecasts that FDI flows are likely to contract by 10–15 per cent in 2016, reflecting the fragility of the global economy, the persistent weakness of aggregate demand, sluggish growth in some commodity exporting countries, effective policy measures to curb tax inversion deals and a slump in MNE profits in 2015 to the lowest level since the global economic and financial crisis of 2008–2009. Elevated geopolitical risks and regional tensions could further amplify the expected downturn. Over the medium term, FDI flows are projected to resume growth in 2017 and to surpass $1.8 trillion in 2018.

Cross-border M&A activity in early 2016 confirms the projected decline of FDI flows. The value of transactions announced during the first four months (including divestments) was 32 per cent lower than during the same period in 2015. This decline reflects new measures imposed by the United States Treasury Department to rein in corporate inversions, which have already resulted in the cancellation of the $160 billion merger of pharmaceutical company Pfizer (United States) with Ireland-based Allergan Plc.

This year's UNCTAD business survey of MNE executives reveals muted overall expectations for 2016, improving over the following two years. In particular, 45 per cent of top MNEs expect to spend less in 2016, compared with 32 per cent spending more; by 2018 this trend will reverse with 44 per cent expecting to spend more.

REGIONAL INVESTMENT TRENDS

Global FDI inflows rose in 2015 but with considerable variance between country groups and regions (table 2).

Low commodity prices hold back FDI to Africa

FDI flows to Africa fell to $54 billion in 2015, a decrease of 7 per cent over the previous year. Dynamic flows into Egypt boosted FDI to **North Africa**, which rose by 9 per cent to $12.6 billion in 2015. Yet this was offset by decreasing flows into Sub-Saharan Africa, as lower commodity prices depressed FDI inflows in natural-resource-based economies. FDI inflows to **West Africa** declined by 18 per cent to $9.9 billion, largely because of a slump in FDI to Nigeria. FDI flows to **Central Africa** fell by 36 per cent to $5.8 billion, as FDI flows to commodity-rich Congo and the Democratic Republic of the Congo declined significantly. **East Africa** received $7.8 billion in FDI – a 2 per cent decrease from 2014. FDI flows to Kenya, however, reached a record level of $1.4 billion in 2015, resulting from renewed investor interest and confidence in the country's business climate and booming domestic consumer market. In **Southern Africa**, FDI flows increased by 2 per cent to $17.9 billion, mainly driven by a record $8.7 billion inflows in Angola, largely due to intracompany loans. Lacklustre economic performance, low commodity prices and higher electricity costs pushed FDI in South Africa to $1.8 billion – the lowest level in 10 years.

FDI outflows from Africa fell by 25 per cent to $11.3 billion. Investors from South Africa, Nigeria and Angola reduced their investment abroad owing to factors such as lower commodity prices, weaker demand from main trading partners, and depreciating national currencies.

FDI inflows to Africa are expected to return to a growth path in 2016, increasing to $55–60 billion. This increase is already becoming apparent in announced greenfield projects in the first quarter of 2016, particularly in North Africa, but also in Mozambique, Ethiopia, Rwanda and United Republic of Tanzania. FDI flows are expected to increase in Kenya and the United Republic of Tanzania which now allow 100 per cent foreign ownership of companies listed on their stock exchanges. Furthermore, privatization of State-owned commodity assets in countries such as Algeria and Zambia should also provide a boost to inflows.

Table 2. FDI flows, by region, 2013–2015
(Billions of dollars and per cent)

Region	FDI inflows			FDI outflows		
	2013	2014	2015	2013	2014	2015
World	**1 427**	**1 277**	**1 762**	**1 311**	**1 318**	**1 474**
Developed economies	680	522	962	826	801	1 065
Europe	323	306	504	320	311	576
North America	283	165	429	363	372	367
Developing economies	662	698	765	409	446	378
Africa	52	58	54	16	15	11
Asia	431	468	541	359	398	332
East and South-East Asia	350	383	448	312	365	293
South Asia	36	41	50	2	12	8
West Asia	46	43	42	45	20	31
Latin America and the Caribbean	176	170	168	32	31	33
Oceania	3	2	2	2	1	2
Transition economies	85	56	35	76	72	31
Structurally weak, vulnerable and small economies	**52**	**55**	**56**	**14**	**14**	**8**
LDCs	21	26	35	8	5	3
LLDCs	30	30	24	4	7	4
SIDS	6	7	5	3	2	1
***Memorandum*: percentage share in world FDI flows**						
Developed economies	47.7	40.9	54.6	63.0	60.7	72.3
Europe	22.7	24.0	28.6	24.4	23.6	39.1
North America	19.8	12.9	24.3	27.7	28.2	24.9
Developing economies	46.4	54.7	43.4	31.2	33.8	25.6
Africa	3.7	4.6	3.1	1.2	1.2	0.8
Asia	30.2	36.6	30.7	27.4	30.2	22.5
East and South-East Asia	24.5	30.0	25.4	23.8	27.7	19.9
South Asia	2.5	3.2	2.9	0.2	0.9	0.5
West Asia	3.2	3.4	2.4	3.4	1.5	2.1
Latin America and the Caribbean	12.3	13.3	9.5	2.5	2.4	2.2
Oceania	0.2	0.2	0.1	0.2	0.1	0.1
Transition economies	5.9	4.4	2.0	5.8	5.5	2.1
Structurally weak, vulnerable and small economies	**3.6**	**4.3**	**3.2**	**1.1**	**1.1**	**0.5**
LDCs	1.5	2.1	2.0	0.6	0.4	0.2
LLDCs	2.1	2.3	1.4	0.3	0.5	0.2
SIDS	0.4	0.6	0.3	0.2	0.1	0.1

Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

FDI flows to Developing Asia hit new records

Developing Asia, with FDI inflows reaching $541 billion – a 16 per cent increase – remained the largest FDI recipient region in the world. The growth was primarily driven by increased FDI in East and South Asian economies. In **East Asia**, FDI rose by 25 per cent to $322 billion, reflecting large equity investments related to a corporate restructuring in Hong Kong (China) and dynamic FDI flows to China's services sector. In **South-East Asia**, FDI to low-income economies such as Myanmar and Viet Nam soared, but this was offset by the lacklustre performance of higher-income countries, including Singapore, Indonesia and Malaysia. India's and Bangladesh's FDI performance pushed inflows to **South Asia** to $50 billion, an increase of 22 per cent from 2014. India became the fourth largest recipient of investment in developing Asia and the tenth largest in the world. In **West Asia**, rising inflows to Turkey partly offset the negative impact of commodity prices and geopolitical challenges on FDI to oil-producing economies, resulting in an overall 2 per cent decline to $42 billion.

After the jump in values recorded in 2015, FDI inflows are expected to revert to their 2014 level. Data on cross-border M&A sales in the first quarter of 2016 and announced greenfield investment projects support the expected slowdown.

Despite the decline in outflows from developing Asia by 17 per cent to $332 billion, the region's outward FDI in 2015 remained the third highest ever. Outward FDI from a number of Asian economies, including China and Thailand, increased. With outflows worth $128 billion, China remained the third largest investing country worldwide. After a surge of outward FDI in 2014, flows from Hong Kong (China) more than halved to $55 billion, due to a large corporate restructuring. **South-East Asia's** outward FDI decreased by 11 per cent to $67 billion, due to a decline in outflows from Singapore. Outward FDI from India, **South Asia's** dominant investor, dropped by more than one third which resulted in an overall 36 per cent decline of outflows from the region to $8 billion. Outflows from **West Asia**, in contrast, soared by 54 per cent to $31 billion mainly due to a turnaround by Kuwait – a major investor in the region.

FDI flows to Latin America and the Caribbean remain flat

FDI to Latin America and the Caribbean – excluding the Caribbean offshore financial centres – stayed flat in 2015 at $168 billion. There were contrasting performances in Central and South America, however. FDI flows to **Central America** rose by 14 per cent to $42 billion, thanks to strong flows to Mexico and higher FDI in manufacturing across the subregion. FDI flows to **South America**, on the other hand, contracted by 6 per cent to $121 billion, reflecting slowing domestic demand and worsening terms of trade caused by falling commodity prices. FDI flows to Brazil, the region's principal recipient, fell 12 per cent to $65 billion. The decline in commodity prices also significantly affected flows to the Plurinational of State of Bolivia, Chile, Colombia, and Peru. In Argentina, FDI surged, albeit compared with abnormally low flows in 2014.

FDI outflows from the region rose by 5 per cent to $33 billion in 2015. In Brazil, outward FDI expanded by a strong 38 per cent, an increase predominantly reflecting a significant reduction in reverse investment by Brazilian foreign affiliates. In Chile, outflows rose 31 per cent to $16 billion.

FDI flows to the region may slow down further in 2016 as challenging macroeconomic conditions persist. In 2015, the value of announced greenfield projects dropped 17 per cent from their 2014 level, led by an 86 per cent decline in the extractive industry. Lower announced project values were also registered in the services sector. On the upside, national currency depreciation may motivate the acquisitions of assets. Cross-border M&As in the first quarter of 2016 were sharply up thanks to higher sales in Brazil, Chile and Colombia.

FDI flows in transition economies declined further in 2015

In 2015, FDI flows to transition economies fell by 38 per cent to $35 billion. The FDI performance of transition subgroups differed: in **South-East Europe**, FDI inflows increased by 6 per cent to $4.8 billion, as better macroeconomic conditions and the EU accession process continue to improve investors' risk perception. In contrast, FDI flows to the **Commonwealth of Independent States (CIS) and Georgia** declined by 42 per cent to $30 billion in a situation of low commodity

prices, weakening domestic markets, regulatory changes, and the direct and indirect impact of restrictive measures/geopolitical tensions. Flows to the Russian Federation slumped to $9.8 billion as new FDI almost dried up due to the scaling back of operations and a string of divestment deals. The economic crisis and regulatory changes in the country have also reduced the scale and scope of round-tripping FDI.

MNEs from transition economies more than halved their FDI flows abroad. Geopolitical tensions, sharp currency depreciation and constraints in capital markets reduced outward FDI to $31 billion in 2015 – a value last recorded in 2005.

After the significant decline recorded in 2015, FDI flows to transition economies are expected to increase modestly in 2016, barring any further escalation of geopolitical tensions in the region. In the CIS, several countries, including Kazakhstan, the Russian Federation and Uzbekistan, have announced large privatization plans, which if realized, will open new avenues for foreign investment.

FDI inflows to developed countries increased sharply

Flows to developed economies nearly doubled to $962 billion due to buoyant cross-border M&As sales. Inflows to **Europe** rose to $504 billion, accounting for 29 per cent of global inflows. This rebound was driven by large increases in Ireland, Switzerland and Netherlands. Other major recipients were France and Germany, both of which recovered sharply from the low points in 2014. Inflows into the United Kingdom fell to $40 billion but remained among the largest in Europe. In 2015, FDI inflows to **North America** reached $429 billion, surpassing the record high of 2000. In the United States FDI almost quadrupled, albeit from a historically low level in 2014.

In 2015, MNEs from developed economies invested $1.1 trillion abroad – a 33 per cent increase from the previous year. **Europe** became the world's largest investing region owing to a strong rebound in their cross-border M&A purchases. Foreign investment by MNEs from **North America** remained flat, with a significant increase in outflows from Canada being offset by a moderate decline of flows from the United States. Japanese MNEs continued to seek growth opportunities abroad, investing more than $100 billion for the fifth consecutive year.

Barring another wave of cross-border M&A deals and corporate reconfigurations, the recovery of FDI activity recorded in 2015 is unlikely to be sustained at the same level in 2016. Recent regulatory measures meant to curb tax inversion deals are likely to discourage cross-border M&A deals and corporate reconfigurations. In addition, the economic growth momentum observed in some large developed economies weakened towards the end of 2015.

FDI to structurally weak and vulnerable economies remains concentrated in extractives industries

FDI flows to the ***least developed countries*** (LDCs) rose by 33 per cent to a record high of $35 billion. In Asia, prospects of deeper economic integration in the ASEAN region spurred FDI in the Lao People's Democratic Republic and Myanmar. FDI flows to Bangladesh hit a record high. Firms from China have become the largest holders of FDI stock in the LDCs, ahead of the United States.

FDI to LDCs as a whole is expected to decrease in 2016, reflecting the continuing lull in FDI to a large number of African economies relying heavily on natural resources. Nevertheless, some major FDI recipients in the group, such as Bangladesh, Ethiopia and Myanmar, are likely to see a rise in their FDI inflows in 2016.

In the ***landlocked developing countries*** (LLDCs), FDI flows fell for the fourth consecutive year to $24.5 billion – a drop of 18 per cent. Transition economy LLDCs accounted for the fall, particularly Kazakhstan, where flows halved. Inflows to the African subgroup also declined, while FDI flows to Asian LLDC economies increased by more than a quarter. In spite of low commodity prices, Asian State-owned firms have been increasingly involved in Central Asia's primary sector. Developing country investors, in particular from China, are holding an increasing share of FDI stock in LLDCs, as they do in LDC economies.

Looking ahead, a surge in the value of announced greenfield investments in the LLDCs provides grounds for optimism. FDI flows to LLDCs, in particular the transition economy subgroup, are expected to increase if large privatization plans materialize.

FDI flows to the ***small island developing States*** (SIDS) dipped by 32 per cent to a five-year low of $4.8 billion. Reduced investment

by energy firms contributed to a contraction in FDI flows to Trinidad and Tobago, the largest FDI host in the group. In Africa, FDI flows to Mauritius fell by 50 per cent, while in Asia and Oceania, the drop in FDI to Maldives and Fiji was less significant. Developing and transition economies now account for the majority of the top 10 investors in SIDS.

FDI prospects in SIDS remain subdued, owing to the lack of large-scale investments in extractive industries and construction. This, however, can be easily overturned by a single investment in, for example, liquefied natural gas or a resort complex project.

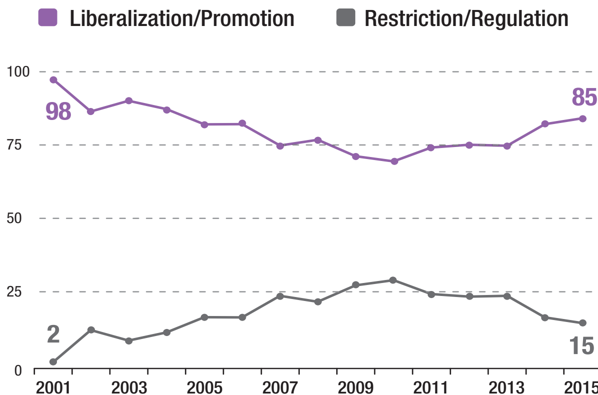
INVESTMENT POLICY TRENDS

National investment policies continue to be geared towards investment liberalization and promotion

UNCTAD data show that, in 2015, 46 countries and economics adopted at least 96 policy measures affecting foreign investment. Of these measures, 71 related to the liberalization and promotion of investment, while 13 introduced new restrictions or regulations on investment (the remaining 12 measures are of a neutral nature). Liberalization and promotion accounted for 85 per cent of investment policy changes, which is above the average of the last five years (2010–2014) (figure 7).

Entry restrictions for foreign investment were eased or eliminated in a broad range of industries (e.g. aviation, financial services, mining, real estate). Some countries pursued privatization policies, in particular in infrastructure sectors. Others improved business licensing procedures, established special economic zones or provided other forms of investment incentives. Another noteworthy feature was the adoption or revision of investment laws, mainly in African countries.

Figure 7. | **Changes in national investment policies, 2001–2015** (Per cent)



Source: ©UNCTAD, Investment Policy Monitor Database.

Newly adopted investment restrictions or regulations largely reflected concerns about foreign ownership in strategic industries or agricultural land. There is a trend towards tightening screening procedures for investments in these sectors.

National security considerations are increasingly part of investment policies; they often cover broader national economic interests

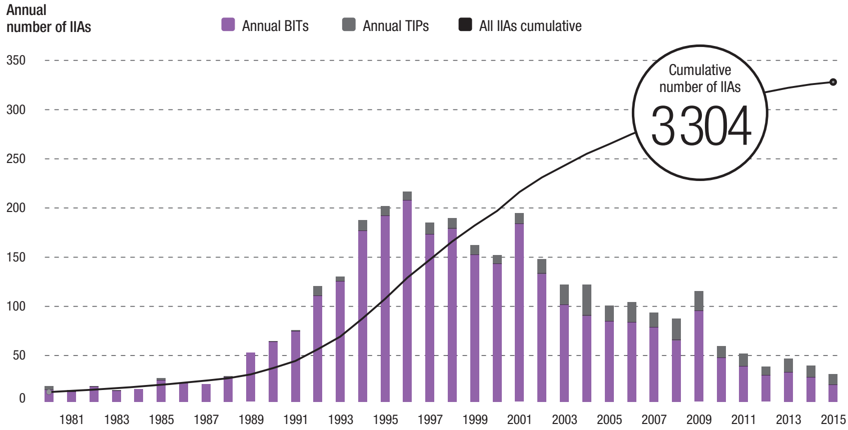
In recent years, national security considerations have gained prominence in investment policies. More countries have adopted legislation in this area or have reviewed foreign investment projects on grounds related to national security. This has a number of policy implications. First, countries use different concepts of national security, ranging from a relatively narrow definition to broader interpretations that extend investment review procedures to critical infrastructure, strategic industries and/or national-interest considerations. Second, countries follow different approaches when restricting foreign investment due to national-security considerations, ranging from formal restrictions in specific sectors to complex review mechanisms that provide the review bodies with ample discretion. Third, review procedures can differ substantially in their disclosure requirements for foreign investors. Governments' space for applying national security regulations needs to be balanced with investors' need for transparent and predictable procedures.

The IIA universe continues to grow

With the addition of 31 new international investment agreements (IIAs) – 20 bilateral investment treaties (BITs) and 11 treaties with investment provisions (TIPs) — the IIA universe grew to 3,304 agreements (2,946 BITs and 358 TIPs) by year-end (figure 8). Although the annual number of new IIAs continues to decrease, some treaties involve a large number of parties and carry significant economic and political weight. Recent IIAs follow different treaty models, and regional agreements often leave existing bilateral treaties between the parties in force, increasing complexity.

Countries most active in concluding IIAs in 2015 were Brazil with six, Japan and the Republic of Korea with four each, and China with

Figure 8. | Trends in IIAs signed, 1980–2015



Source: ©UNCTAD, IIA Navigator.

three. Brazil is taking a new approach to BITs, focusing on investment promotion and facilitation, and on dispute prevention and alternatives to arbitration.

The first four months of 2016 saw the conclusion of nine new IIAs (seven BITs and two TIPs), including the Trans Pacific-Partnership (TPP) Agreement, which involves 12 countries. By end-May 2016, close to 150 countries and economies were engaged in negotiating at least 57 new IIAs (including megaregional treaties such as the Transatlantic Trade and Investment Partnership (TTIP) and the Regional Comprehensive Economic Partnership (RCEP)).

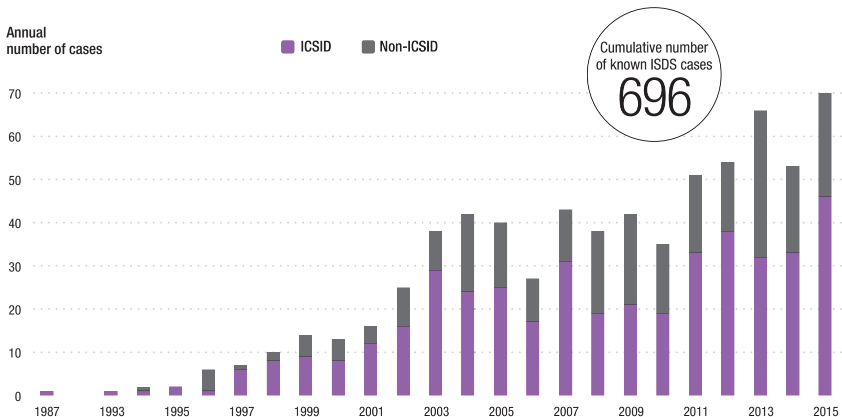
At the same time, some countries terminated their IIAs in 2015. Typically, however, by virtue of survival clauses, investments made before the termination of these IIAs will remain protected for periods ranging from 10 to 20 years, depending on the relevant provisions of the agreements and the terms of termination.

The number of new treaty-based ISDS cases reached a record high, with a continued large share of cases against developed countries

In 2015, investors initiated 70 known ISDS cases pursuant to IIAs, which is the highest number of cases ever filed in a single year (figure 9). As arbitrations can be kept confidential under certain circumstances, the actual number of disputes filed for this and previous years is likely to be higher. As of 1 January 2016, the total number of publicly known ISDS claims had reached 696. One hundred and seven countries have been respondents to one or more known ISDS claims.

Following the recent trend, a high share of cases (40 per cent) was brought against developed countries, including many cases by European investors against European Union member States. The majority of new cases were brought under BITs; the Energy Charter Treaty was invoked in about one third of cases. Publicly available arbitral decisions in 2015 indicated that States often prevailed at the jurisdictional stage of proceedings, and investors won more of the cases that reached the merits stage.

Figure 9. | Known ISDS cases, annual and cumulative, 1987–2015



Source: ©UNCTAD, ISDS Navigator.

IIA reform is intensifying and yielding the first concrete results

Reform to bring the IIA regime in line with today's sustainable development imperative is gaining momentum. A new generation of investment treaties is emerging. In 2015, UNCTAD's WIR laid out a road map for IIA reform, providing six guidelines, addressing five reform areas, and outlining options for action at four levels of policymaking. UNCTAD's Investment Policy Framework and its Road Map for IIA Reform are shaping key reform activities.

At the national level, numerous countries are reviewing their IIA network and/or developing a new treaty model. About 100 countries (including those that undertook a review as part of the Regional Economic Integration Organization (REIO)) have used the UNCTAD's Investment Policy Framework to reassess their IIA networks. About 60 of these have used the Framework to design treaty clauses.

At the bilateral level, the reform drive is most prominently reflected in the negotiation of new IIAs. Most of the treaties recently concluded include several sustainable-development-friendly clauses.

At the regional level, IIA reform actions include collective treaty reviews and IIA action plans, which can result in common IIA models, joint interpretations, renegotiations, and/or the consolidation of treaties. Megaregional agreements could consolidate and streamline the IIA regime and help enhance the systemic consistency of the IIA regime, provided they replace prior bilateral IIAs between the parties (*WIR14*).

IIA reform at the multilateral level is the most challenging path. The UNCTAD Road Map identifies several possible options for multilateral IIA reform with different levels of intensity. The importance of multilateral consultations on IIAs for the pursuit of today's sustainable development agenda has been recognized in the Addis Ababa Action Agenda, the outcome document of the Third UN Conference on Financing for Development, held in July 2015. In the Addis Ababa Action Agenda, Member States asked UNCTAD "to continue its existing programme of meetings and consultations with Member States on investment agreements."

During this first phase of IIA reform, countries have built consensus on the need for reform, identified reform areas and approaches, reviewed their IIA networks, developed new model treaties and started to negotiate new, more modern IIAs. Despite significant progress, much remains to be done.

First, comprehensive reform requires a two-pronged approach: negotiating new, more modern IIAs, but also modernizing the existing stock of treaties. Second, reform has to address the challenge of increasing fragmentation: only a common approach will effectively and efficiently deliver an IIA regime in which stability, clarity and predictability help achieve the objectives of all stakeholders. Unlike the first phase of IIA reform, where most activities took place at the national level, phase two of IIA reform will require countries to intensify collaboration and coordination among treaty partners to address the systemic risks and incoherence of the large body of old treaties. The 2016 World Investment Forum offers the opportunity to discuss how to carry IIA reform to the next phase.

Filling a systemic gap in investment facilitation

Facilitating investment is crucial for the post-2015 development agenda. Facilitation is different from investment promotion. Promotion is about marketing a location as an investment destination and is therefore often country-specific and competitive in nature. Facilitation is about making it easier for investors to establish or expand their investments and to conduct their day-to-day business.

Investment facilitation can include improvements in transparency and information available to investors; work towards efficient and effective administrative procedures for investors; enhancing the consistency and predictability of the policy environment for investors through consultation procedures; and mitigating investment disputes through ombudspersons.

To date, national and international investment policies pay relatively little attention to investment facilitation. From the 173 new investment promotion and facilitation policies that were introduced around the world between 2010 and 2015, only a minority relate to investment facilitation. At the international level, concrete investment

promotion and facilitation actions are either absent or weak in the great majority of the existing 3,304 IIAs.

UNCTAD's Global Action Menu for Investment Facilitation, which builds on UNCTAD's 2012 Policy Framework and its rich experience and practices of investment promotion and facilitation efforts worldwide over the past decades, responds to this systemic gap in investment policies. It consists of 10 action lines that provide over 40 options for investment policymakers to adapt and adopt for national and international policy needs.

- Action line 1 – Promote accessibility and transparency in the formulation of investment policies, regulations and procedures relevant to investors
- Action line 2 – Enhance predictability and consistency in the application of investment policies
- Action line 3 – Improve the efficiency and effectiveness of investment administrative procedures
- Action line 4 – Build constructive stakeholder relationships in investment policy practice
- Action line 5 – Designate a lead agency or investment ombudsperson/facilitator with a specific mandate
- Action line 6 – Establish monitoring and review mechanisms for investment facilitation
- Action line 7 – Enhance international cooperation for investment facilitation
- Action line 8 – Strengthen investment facilitation efforts in developing-country partners through technical assistance
- Action line 9 – Enhance investment policy and proactive investment attraction in developing-country partners
- Action line 10 – Enhance international cooperation towards investment promotion for development, including through provisions in IIAs

The Action Menu includes measures that countries can choose to implement unilaterally and options that can guide international collaboration or can be incorporated in IIAs.

Any investment facilitation initiative cannot be considered in isolation from the broader sustainable development agenda. It is important to address weaknesses in investment facilitation capabilities where they exist in developing countries. Effective investment facilitation efforts should be an integral part of the overall investment policy framework (including regulation, liberalization, protection and promotion) aimed at maximizing the benefits of investment and minimizing any negative side effects or externalities.

INVESTOR NATIONALITY: POLICY CHALLENGES

More than 40 per cent of foreign affiliates worldwide have multiple "passports"

Firms, and especially affiliates of multinational enterprises (MNEs), are often controlled through hierarchical webs of ownership involving a multitude of entities. More than 40 per cent of foreign affiliates are owned through complex chains with multiple cross-border links involving on average three jurisdictions (figure 10). That implies that the nationality of investors in, and owners of, foreign affiliates is becoming increasingly blurred.

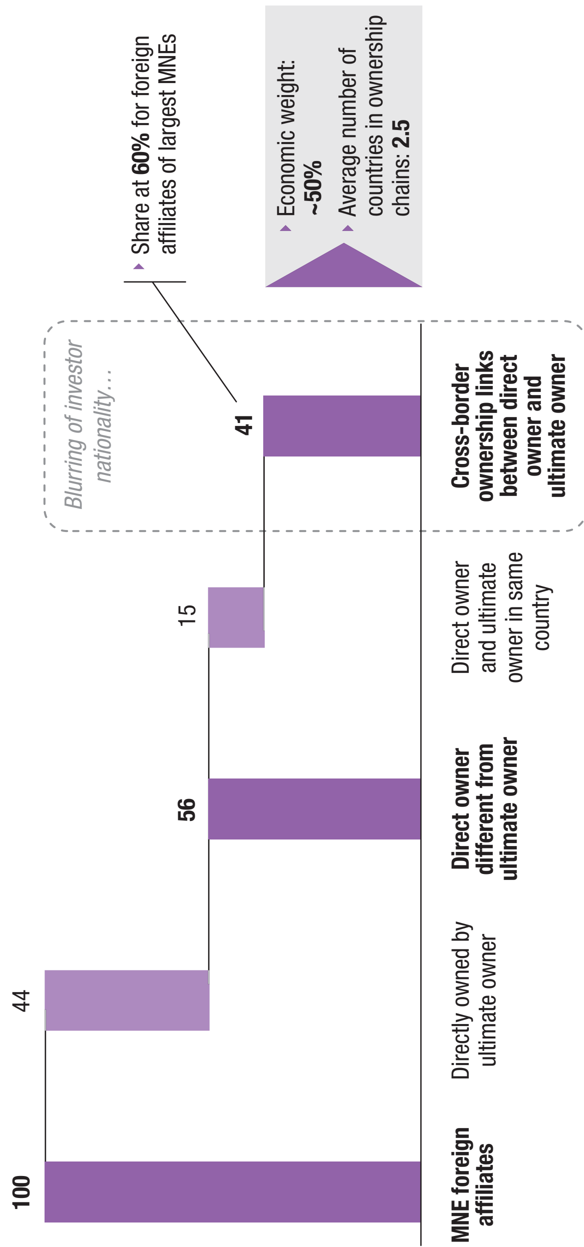
The blurring of investor nationality has important implications for national and international investment policies. Most countries have investment rules and promotion tools that are conditional on ownership and nationality. Almost 80 per cent of countries worldwide prohibit majority foreign ownership in at least one industry. Bilateral and regional investment agreements aim to provide benefits only to investors originating in the jurisdictions of treaty partners.

In designing national investment policies and in negotiating investment agreements, policymakers need to consider carefully the effectiveness and suitability of ownership-based measures, as well as the practical implications for their application and enforcement.

The largest MNEs have ownership networks involving over 500 affiliates across more than 50 countries

Common types of complexity in internal MNE ownership structures are lengthy ownership chains with multiple cross-border links, ownership hubs and shared ownership structures. Ownership of affiliates is expressed in shareholdings, which provide cash-flow rights and voting rights. Control is the ability to exercise voting rights to affect strategic management decisions. In the internal ownership structure of MNEs, control generally coincides with (direct or indirect) majority ownership. However, MNEs can exercise control over affiliates even when they have a minority stake.

The universe of MNEs is highly skewed: a very large group of MNEs is simple, with few affiliates directly and fully owned by the



Source: ©UNCTAD analysis based on Orbis data.

parent company. A very small group of MNEs accounts for a large share of foreign affiliates. Less than one per cent of MNEs have more than 100 affiliates, but these account for more than 30 per cent of all foreign affiliates and almost 60 per cent of global MNE value added.

The larger the MNEs, the greater the complexity of their internal ownership structures is. The top 100 MNEs in UNCTAD's Transnationality Index have on average more than 500 affiliates across more than 50 countries, seven hierarchical levels in their ownership structure (i.e. affiliates could potentially have seven "passports"), about 20 holding companies owning affiliates across multiple jurisdictions, and almost 70 entities in offshore investment hubs.

MNE ownership structures are often the result of historical accident or haphazard growth patterns. Even when MNEs wish to simplify ownership structures in "entity reduction programmes", they are often prevented from doing so because of legal and fiscal constraints, or arrangements with banks. Where MNEs deliberately incorporate elements of complexity (e.g. lengthy ownership chains, multiple owners of affiliates, or different locations of direct versus ultimate owners), these are most often dictated by governance rules and risk management, financing, tax, and other institutional or policy-related considerations. Investment policy is one of several policy drivers behind complex ownership structures.

The long-term trends causing an increasing share of international production to be concentrated in the largest MNEs are also likely to result in increasing complex MNE ownership worldwide.

"Multiple passport affiliates" are the result of indirect foreign ownership, transit investment through third countries, and round-tripping

Insights on the ownership structures of MNEs as a whole (top-down perspective) are useful to show overall complexity. However, for investment policymakers, a bottom-up perspective looking at the ownership chain starting from the foreign affiliate, through its direct owners, and up to its ultimate owner can be more helpful. For WIR16, UNCTAD has developed a firm-level dataset including some 4.5 million companies that enables a bottom-up approach.

Comparing domestic and foreign direct owners and ultimate owners (in a two-by-two ownership matrix) leads to the identification of ownership scenarios relevant to investment policy in which the direct owners and ultimate owners of an affiliate are based in different jurisdictions. These nationality "mismatch" cases – more than 40 per cent of all foreign affiliates and 50 per cent when measured by revenues – include:

- Indirectly foreign owned companies – about 30 per cent of foreign affiliates are owned through a domestic entity

- Transit investments – just over 10 per cent of foreign affiliates are owned through an intermediate entity in a third country

- Round-tripping – about 1 per cent of foreign affiliates are ultimately owned by a domestic entity

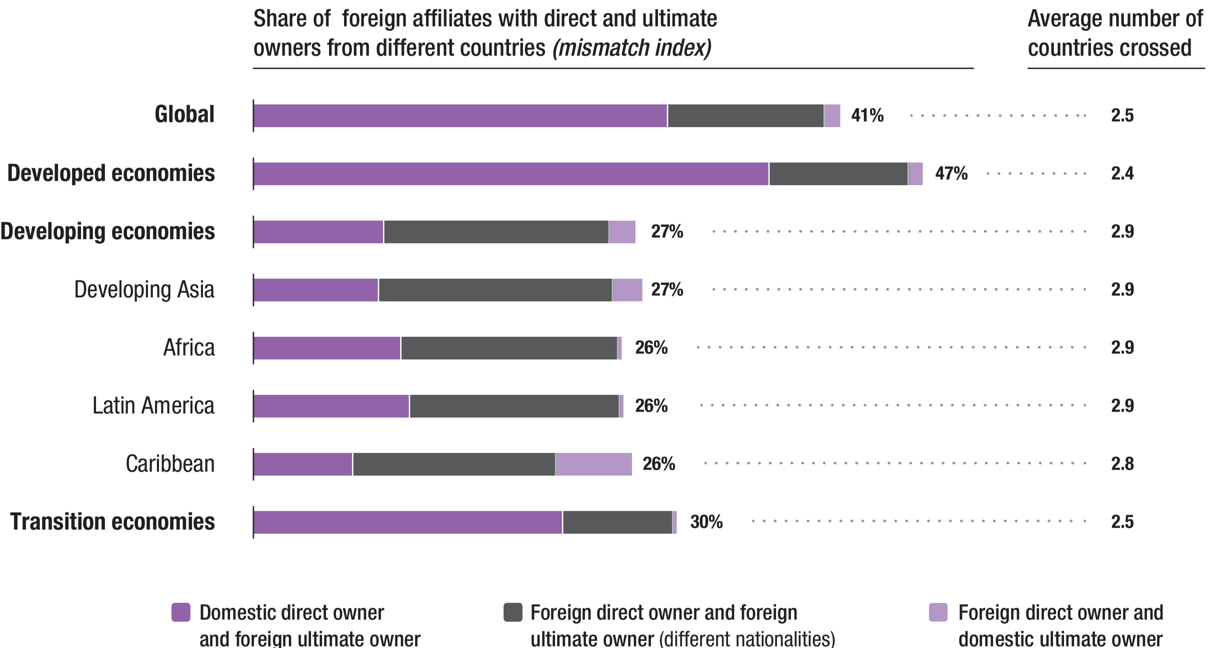
The investor nationality "mismatch index" is considerably higher for the largest MNEs: 60 per cent of their foreign affiliates have multiple cross-border ownership links to the parent company.

Mismatches involve almost half of foreign affiliates in developed economies, and more than a quarter in developing economies. Whereas most mismatches in developed countries are caused by multi-layered ownership structures within host countries, in developing countries they are more often the result of investments transiting through third countries (figure 11).

Rules on foreign ownership are widespread: 80 per cent of countries restrict majority foreign ownership in at least one industry

National and international investment policy measures that differentiate between domestic and foreign companies or between foreign investors of different nationalities include entry restrictions and ownership caps; operating restrictions or performance requirements; investment facilitation and incentives; and investment protection. These measures are most often driven by national security concerns; protection of national and strategic assets; industrial development and competition policies; social, cultural or political concerns; and regional integration policies.

Figure 11. The investor nationality mismatch index by region



Source: ©UNCTAD analysis based on Orbis data.

Complex ownership structures and investor nationality mismatches make the application of rules and regulations on foreign ownership more complex. They also raise important questions about the coverage of IIAs. For national investment policies, the distinction between domestic and foreign investment is important. Therefore, the most relevant nationality mismatches are investments that are indirectly foreign owned through a domestic entity, and round-tripping investments. For IIAs, the distinction between different nationalities of investors is important. Therefore, the most relevant mismatch cases are transit investments through third countries and, again, round-tripping investments.

At the national policy level, rules and regulations about foreign ownership are widespread. Services are relatively more affected by foreign equity limitations, in particular in media, transportation, communication, utilities and financial and business services. Extractive industries and agriculture are also frequently regulated through ownership restrictions. The trend in ownership-related measures since 2010 is towards liberalization, through the lifting of restrictions, increases in allowed foreign shareholdings, easing of approvals and admission, and greater access to land for foreign investors. However, many ownership restrictions remain in place in both developing and developed countries.

The blurring of investor nationality has made the application of rules and regulations on foreign ownership more challenging

The determination of investor nationality is part of foreign-investment registration and approval procedures; sector-specific licensing (when foreign ownership restrictions apply); and national-security-related foreign investment reviews. Approval procedures covering all sectors, including those without ownership restrictions, exist in many countries. Disclosure requirements for investors vary by country; not all regulators and authorities require disclosure of ultimate ownership. National-security reviews tend to examine the full ownership structure of MNEs.

Ownership complexity has made the effective implementation and enforcement of ownership restrictions and ownership-based rules

and regulations difficult and burdensome. Key challenges for national investment policymakers are (i) how to assess aggregate direct and indirect ownership, (ii) how to prevent de facto foreign control, and (iii) how to avoid undue access to benefits reserved for foreign investors by host State nationals. Policymakers in some countries have developed a range of mechanisms to safeguard the effectiveness of foreign ownership rules, including anti-dummy laws, general anti-abuse rules to prevent foreign control, and disclosure requirements aimed at monitoring ownership- and non-ownership-based control.

Indirect ownership structures and mailbox companies have also raised challenges for IIAs

In international investment policymaking, ownership chains have the potential to significantly expand the reach of IIAs. About one third of investor-State dispute settlement (ISDS) claims in 2010–2015 are filed by claimant entities that are ultimately owned by a parent in a third country (not party to the treaty on which the claim is based). More than a quarter of these claimants do not have substantial operations in the treaty country – this share can increase up to 75 per cent considering claims based on treaties concluded by major ownership hub locations.

IIAs increasingly circumscribe their coverage in response to three specific challenges: claims brought (i) by entities controlled by a third-country or host-State entity (round-tripping), (ii) by mailbox companies, or (iii) by entities with ownership links to the investment that were purposely created in anticipation of a claim (time-sensitive restructuring). They can do so through more restrictive definitions and through denial of benefits (DoB) clauses. In addition, IIAs can clarify the meaning of effective control, if necessary urging tribunals to ascertain the ultimate owner controlling the relevant investment. To rule out claims by mailbox companies, IIAs can require that claimants have substantial business activities (SBA) and provide indicators for what might constitute SBA. Finally, IIAs can deny ISDS access to entities that have restructured at a time when a dispute had already arisen or was foreseeable. However, only half of the new IIAs (those concluded since 2012) and hardly any of the older IIAs include DoB clauses.

Ownership-based investment policies need a re-think to safeguard their effectiveness

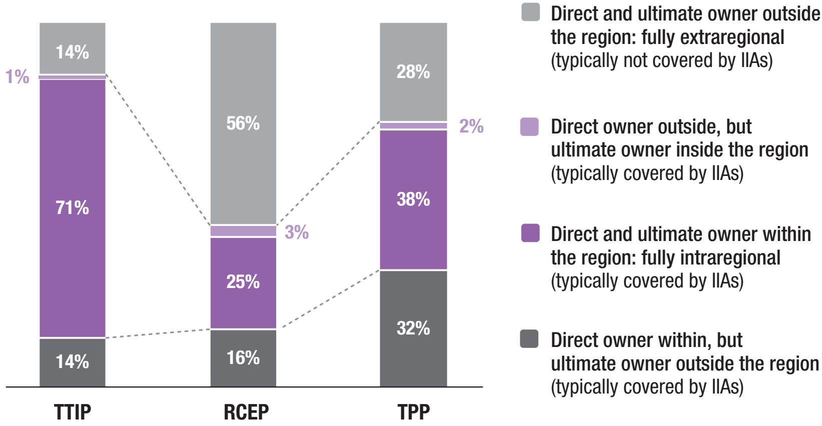
The increasing complexity of MNE ownership networks is largely a consequence of globalization. The practical difficulty of determining ultimate ownership of, and control over, foreign affiliates call into question the effectiveness of some ownership-based investment policies. Policymakers should evaluate the rationale for rules and regulations on foreign ownership and assess their relative effectiveness and "fit-for-purpose" compared with alternative policies (such as competition or industrial development policies), where this is feasible and appropriate. Some countries may require assistance, including by international organizations, to build the necessary regulatory and institutional capacity.

Where ownership-based policies are considered necessary, investment authorities can improve disclosure requirements to assess ownership chains and ultimate ownership. They should be aware of the administrative burden this can impose on public institutions and on investors. Synergies with other agencies in policy areas that investigate ownership chains, such as competition authorities and tax authorities, should be exploited.

Complex MNE ownership structures have a multilateralizing effect on IIAs

At the international level, policymakers should be aware of the de facto multilateralizing effect of ownership complexity. The broad definition of investors/investments in investment treaties, combined with large MNEs' extensive networks of affiliates and the ease of establishing legal entities in many jurisdictions, significantly extend the coverage of IIAs. This is highly relevant also for regional treaties and treaty negotiations: between one seventh (TTIP) and one third (TPP) of apparently intra-regional foreign affiliates in major megaregional treaty areas are ultimately owned by parents outside the region, raising questions as to the ultimate beneficiaries of these treaties and negotiations (figure 12).

Figure 12. **Ownership of foreign affiliates in TTIP, RCEP and TPP**
Origin of direct and ultimate owners of foreign affiliates



Source: ©UNCTAD analysis based on Orbis data.

Policymakers should aim to avoid uncertainty for both States and investors about the coverage of the international investment regime and its multitude of bilateral, regional and megaregional treaties. International collaboration could aim to build a common understanding of "effective control" and a common set of criteria for substantial business activity and for identifying the origin of investors, as a basis for a more consistent interpretation of investment rules and treaty coverage, and as an integral part of global efforts to facilitate international investment.

* * *

In conclusion, the overarching objective of investment policy is to make investment work for sustainable development, maximizing its benefits and minimizing its negative effects. Complex ownership structures call into question the effectiveness of ownership-based policy tools widely used for this purpose, both nationally and internationally. This requires a re-evaluation of these tools for the pursuit of the common goal.

One approach is to enhance the application of ownership-based regulations by improving disclosure requirements and procedures to identify the ultimate owner of an investment. Another approach is to replace, where feasible and appropriate, ownership-based regulations with other policies such as competition, taxation, industrial development, public services or cultural policies. It is important to find the right policy mix, effective and proportionate. Whichever approach is chosen, a balance between liberalization and regulation must be found in pursuing the ultimate objective of promoting investment for sustainable development.

To help policymakers chart a way forward, WIR16 provides insights on the global map of ownership links in MNEs and on how national and international policymakers around the world can respond to the challenges posed by complex ownership structures. The new data, empirical analysis, and policy responses presented here can inspire further research to support better informed policy decisions. They also make a strong case for targeted technical assistance and capacity building, and for more international consensus building. UNCTAD will continue to support these efforts.

BOOK REVIEW

Reshaping the Investor-State Dispute Settlement System: Journeys for the 21st Century

Jean E. Kalicki and Anna Joubin-Bret, editors
(Leiden, Netherlands: Konindlijke Brill, 2015),
1003 pages with index

No issue is of greater consequence to the rapidly expanding field of international investment law than the issue of whether sovereign states should continue to utilize existing mechanisms for the arbitration of investment disputes with investors. Jean Kalicki and Anna Joubin-Bret have made a magnificent contribution to the discussion of that issue with their collection of papers. This book is neither an assault upon, nor an apology for, investor-state arbitration. Rather, the contributors to this volume have sought a middle ground by endeavouring to propose very concrete ways in which to reform investor-state arbitration in response to many of the most common criticisms of that form of investment dispute resolution.

The contributors are a diverse mix of experts drawn from Europe, Asia and North and South America. They comprise arbitrators, attorneys, academics and current or former officials of both national governments and international organizations. Some contributors offer personal observations from a position at the centre of events, while others have mined empirical data or the existing arbitral awards for insights into the process. Though varying widely in length, the papers in the collection are thoughtful, well researched, and avowedly practical.

The book traces its origins to a 2013 proposal by Mark Kantor that the online journal, *Transnational Dispute Management*, publish a special issue titled, "The Reform of Investor-State Dispute Settlement: In Search of a Roadmap". He asked Jean Kalicki and Anna Joubin-Bret, both deeply experienced, to edit the issue, which appeared in January 2014 as a collection of 65 papers by 85 authors. For this printed volume with its physical constraints on space, the editors pared the collection down to 38 papers by 48 authors.

Although this review cannot begin to do justice to the scope and depth of analysis in these papers, the reader may find illuminating a brief survey of the collection as a whole.

Christoph Schreuer's contribution reviews the deficiencies of diplomatic protection and adjudication in local courts and concludes that investor-state arbitration remains "the only functioning system for the orderly settlement of the numerous disputes arising from foreign investments" (p. 889). Schreuer's conclusion captures the premise of many of the papers in this collection, *viz.*, that the investor-state arbitral process exists because of the lack of suitable alternatives and thus reform should be directed at improving the process while preserving the advantages that the process has brought to the resolution of international investment disputes.

Several of the papers propose ways to divert certain disputes from investor-state arbitral tribunals to a different mechanism, suggesting that the authors of these papers do believe that a better alternative exists for at least some disputes. Daniel Kalderimis proposes to divert some disputes to local courts by reintroducing, under certain conditions, the requirement that local remedies be exhausted prior to submitting a claim to arbitration. Mark Feldman proposes criteria for distinguishing between companies acting as exporters and those acting as investors, thus providing a jurisdictional basis for excluding claims by the former from investor-state arbitration. Anne Van Aaken proposes that the resolution of certain disputes be delegated to a joint commission representing the treaty parties. Theodore R. Posner and Marguerite C. Walter also call for greater use of state-state processes, including state-state arbitration, as an alternative to investor-state arbitration in certain types of cases. Locknie Hsu offers proposals for the development of new forms of alternative dispute resolution for some cases, drawing on insights from trade and commercial law.

By contrast, some contributors resist proposals to reduce the remit of investor-state arbitral tribunals. Liang-Ying Tan and Amal Bouchenaki caution against reform proposals that would limit investor access to investor-state arbitration and suggest instead revisions to investment treaties and to the arbitral process. Similarly, Nicolette Butler considers the possibility of diverting claims to existing international dispute settlement mechanisms, but concludes that none of them is

suitable, although she suggests incorporating specific features of these mechanisms into existing international arbitral processes.

One contributor would actually *increase* the scope of disputes resolved through investor-state arbitration, in at least one respect. José Antonio Rivas suggests expanding the use of investor-state arbitral tribunals to resolve counterclaims.

The most common approach to reform in this collection is to impose greater control over investor-state arbitral tribunals so that mistaken interpretations of the relevant treaties can be avoided or corrected and greater consistency achieved. Proposals of this type take several forms.

In some instances, the contributors would provide clearer guidance to tribunals, thus preventing mistaken interpretations and creating a more consistent jurisprudence. Elizabeth Boomer recommends that countries revise the language of international investment agreements to provide investor-state arbitral tribunals with more specific guidance and she includes an appendix in which she offers specific treaty language and explanatory commentary on her proposed language. Baiju S. Vasani and Anastasiya Ugale call for greater use by tribunals of *travaux preparatoires* to find the intended meaning of treaty provisions. Joshua Karton suggests the creation of an Advisory Committee on International Investment Law that would provide authoritative guidance to tribunals. Roberto Castro de Figueiredo proposes that the ICSID Administrative Council adopt interpretive resolutions that contain authoritative interpretations of the ICSID Convention. Michael Ewing-Chow and Junianto James Losari recommend greater use of the mechanism pioneered in the NAFTA allowing the treaty parties to issue binding interpretations of treaty provisions. Tomoko Ishikawa similarly recommends a mechanism whereby the treaty parties issue joint interpretations of treaty language.

In other cases, the contributors would institute additional mechanisms for reviewing and potentially invalidating awards, thus correcting (and perhaps deterring) mistaken interpretations and, again, promoting a more consistent jurisprudence. Several of the contributors discuss the creation of an appellate mechanism. Gabriel Bottinini argues that such a mechanism is needed, while Luis González García and Kristina Anđelić, in separate papers, argue that it is not and they

recommend various alternative approaches. Barton Legum takes a middle position, suggesting that an appellate mechanism may perhaps be needed in the specific context of the Trans-Pacific Partnership Agreement and the Transatlantic Trade and Investment Partnership Agreement, but is unnecessary as a general matter. Two contributors, Eun Young Park and Jaemin Lee, contribute chapters with very specific recommendations regarding the ways in which an appellate mechanism should operate.

One means of reviewing awards that is already in widespread use is the procedure for annulment of ICSID awards. Nikolaos Tsolakidis describes the continuing concern that ICSID annulment committees are exceeding the scope of their authority under the ICSID Convention and are functioning as appellate bodies, in effect, exercising too much control over investor-state arbitral tribunals. Diego Brian Gosis suggests that the problem is not too much review, but too little. He would amend the ICSID Convention to permit rectification of any kind of error in an award and to authorize annulment of awards on the basis of a manifest error of law or fact.

Two of the contributors – Omar E. García-Bolívar and Eduardo Zuleta – address concerns about the legitimacy and consistency of investor-state arbitral awards that arise from the way that arbitral tribunals are constituted. In separate papers, they advocate the creation of a permanent investment tribunal that would supplant the current system of investor-state arbitration, in which a different tribunal is constituted for each dispute.

Several of the contributors focus on concerns not about the substantive results of investor state arbitration, but about the cost and delay involved in the process. Some would reduce the cost of the process by discouraging nonmeritorious claims. Jeffrey Sullivan, David Ingle and Matthew Hodgson offer a set of papers suggesting different ways to use cost awards to deter nonmeritorious claims and dilatory tactics. Mallory Silberman proposes means for reducing the number of nonmeritorious petitions for ICSID annulments. Others focus on expediting the arbitral process. Adam Raviv offers 29 specific recommendations for shortening the time needed for ICSID arbitration, while Joongi Kim reviews several sources of delay and focuses on modifying the process for closing arbitral proceedings more promptly.

A final group of papers, rather than suggesting particular reforms, examines the reform process itself in search of insights regarding how reform can or should proceed. Antonio R. Parra discusses the process that led to the 2006 amendments to the ICSID Regulations and Rules, while Julia Salasky and Corinne Montineri describe the adoption of the UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration. Karen L. Kizer and Jeremy K. Sharpe describe how reforms to the investor-state arbitral process can be achieved through the negotiation of international investment agreements, focusing on the U.S. experience. J. J. Saulino and Josh Kallmer examine some of the political realities underlying the investment treaty negotiations that shape investor-state arbitration. Jan Asmus Bischoff discusses the role of the European Union in the future development of international investment law. David Gaukrodger and Kathryn Gordon describe the work of the Freedom of Investment Roundtable hosted by the Organisation for Economic Co-operation and Development in promoting reform. Silvia Constain suggests convening an ad hoc committee of ICSID members to develop a model international investment agreement that would bring uniformity to substantive provisions and establish a standing dispute settlement mechanism with an appellate body. Steven W. Schill argues that reform must entail a reconceptualization of investor-state arbitration as a form of public law based judicial review.

As this brief survey indicates, the many proposals in this collection vary greatly. Some proposals are more novel than others. Some are more sweeping than others. The real virtue of this collection, however, is that, in each case, the contributors have focused on the practical aspects of their proposals. That is, they identify a problem that calls for solution and then they offer a solution. For one in search of a constructive guide to reform, there is no better place to start.

Kenneth J. Vandevelde
Professor of Law, Thomas Jefferson School of Law
United States

GUIDELINES FOR CONTRIBUTORS

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Dunning, John H. (1979). "Explaining changing patterns of international production: in defence of the eclectic theory", *Oxford Bulletin of Economics and Statistics*, 41 (November), pp. 269–295.

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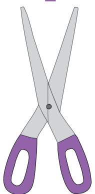

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