

VOLUME 14

NUMBER 2

AUGUST 2005

TRANSNATIONAL CORPORATIONS



United Nations
New York and Geneva, 2005
United Nations Conference on Trade and Development
Division on Investment, Technology and Enterprise Development

Editorial statement

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ISBN 92-1-112690-8
ISSN 1014-9562
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Professor Sanjaya Lall, a member of the Board of Advisers of *Transnational Corporations*, died on 18 June 2005 at his home in Oxford. It is a great loss not only to his family, but also to our common work devoted to promoting development. Professor Lall was a renowned authority and made a great contribution to our knowledge of investment, industrialization, trade, technology and development.

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Transnational Corporations

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Went for cost, priced at cost? An economic approach to the transfer pricing of offshored business services

Lorraine Eden *

What are the implications of the rapid growth in offshored business services for transfer pricing, the pricing of products traded between affiliated firms? I explore these implications through a case study of transnational corporations in the teleservices industry. Teleservices firms own foreign affiliates that provide inbound and outbound call services to third party clients. Economic analysis, applied to the facts and circumstances of the industry, is used to develop pricing rules for offshored call centres, including the implications for location savings. Even though the catchphrase “Went for cost, stayed for quality” does apply to teleservices as it does in other offshored business services, I conclude that “Went for cost, priced at cost” is the appropriate transfer-pricing maxim for tax authorities and firms to follow.

Key words: offshoring, outsourcing, transfer pricing, business services, teleservices, international taxation

1. Introduction

International trade and foreign direct investment (FDI) patterns are increasingly shifting from manufacturing to services (UNCTAD, 2004). The reasons for the rapid growth in services trade and FDI are straightforward. First, transnational corporations (TNCs) in service industries such as airlines, banking, accounting and consulting are rapidly becoming

* Professor of Management at Texas A&M University in the United States. Jennifer Rhee, Marcos Valadao and three anonymous reviewers provided helpful comments on an earlier version of this article. Contact: leden@tamu.edu.

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transnationalized. The privatization of State-owned enterprises in service industries such as telecommunications, electricity and postal services has encouraged inward FDI, particularly in Latin America and Central and Eastern Europe. Second, TNCs in the manufacturing sector are setting up foreign affiliates to provide support functions for the corporate group; financial, trading and marketing affiliates are common examples. Information technology enabled services (ITES), providing back office and support functions (payroll, order fulfillment) and front office functions (customer care), are being relocated to developing countries such as India and the Philippines. Information technology has enabled the disassembly of service processes into a number of relatively separable activities; codifiable interfaces between these activities enable them to be allocated to legally independent organizations and placed in physically distant locations. While the original move offshore for most TNCs was caused by the availability of low-cost labour, both quality and cost are now key drivers of services FDI, as reflected in the maxim: “Went for cost, stayed for quality” (Dossani and Kenney, 2003, 2004).

The research question I address in this article is: what are the implications for transfer pricing of the rapid growth of FDI in business services? *Transfer pricing* is the pricing of products traded among affiliated units of a TNC. Because the prices are set in-house, there are opportunities for TNCs to manipulate them and avoid or evade Government regulations such as customs duties and corporate income taxes. In order to curtail these opportunities, most Governments have adopted transfer-pricing regulations based on the OECD guidelines (OECD, 1995). These guidelines require TNCs to follow the arm’s length principle, i.e. firms must price each intracompany transaction as if it had occurred between two unrelated parties negotiating for the same product under the same circumstances as the related party firms (Eden, 1998, 2001; IRS, 1994; OECD, 1995). Transfer pricing is, and has been for many years, the most contentious issue in international taxation due to the difficulties involved in setting arm’s length prices acceptable to both tax authorities and TNCs (Ernst & Young, 2003; UNCTAD, 1999). Comparable transactions between unrelated parties are often not

available for intrafirm transactions in goods, much less for intangibles and services. Thus, transfer pricing is an area fraught with difficulties and pitfalls for the unwary.

This article explores the implications for transfer pricing of the new trend in offshoring of business functions. As TNCs move business services offshore, they must develop transfer-pricing policies for pricing these intracompany transactions. At the same time, both home and host Governments must apply the arm's length standard to these transactions. However, transfer-pricing regulations for services are much less developed than for goods and raw materials (Feinschreiber, 2004; Eden, 1998). TNCs are expected to follow the benefit-cost principle, with little explicit guidance as to acceptable methodologies compared to the detailed guidelines available for goods transactions (OECD, 1995; IRS, 1994).

Despite, or perhaps because of, the lack of regulation, transfer pricing of services has been a particularly controversial area of transfer pricing regulation. Ernst & Young (2003, p. 12), for example, found that 43% of parent TNCs believed their transfer-pricing policies for administrative/managerial services were vulnerable to Government audit; 30% believed their pricing of technical services were also vulnerable. Ernst & Young argued that audits of services were increasing as a share of all transfer-pricing audits, partly because few TNCs documented transfer-pricing policies for administrative or managerial services. With no or minimal documentation, these transactions "appear to be the 'weakest link' in an MNE's transfer pricing armor" (Ernst & Young, 2003, p. 12). The rapid growth in offshoring business services should therefore exacerbate already high tensions in this area of transfer-pricing regulation. Aliff Fazelbhoy (2005, p. 33), for example, states: "The tax treatment of outsourcing in India has been a source of heated debate and stand-offs between industry and tax authorities".

This raises the following issue: can the existing transfer pricing rules for services, as outlined in OECD (1995) and IRS (1994), continue to apply, or are new rules needed for pricing

intrafirm transactions in offshored business services? Some tax authorities clearly believe that the issues are sufficiently different that new rules are needed. For example, the Central Board of Direct Taxes in India, which adopted its first transfer pricing regulations in 2001, recently issued two circulars on outsourced business services (Fazelbhoy, 2005). The United States Treasury has proposed new transfer pricing regulations designed to harmonize transfer-pricing methodologies for pricing intragroup services with already existing rules for goods (IRS, 2003). Both policy changes appear to be motivated by the rapid expansion of international intrafirm trade in business services, and the rising knowledge intensity of production (UNCTAD, 2003).

Because individual facts and circumstances are highly important in determining the most appropriate (“best method”) transfer pricing methodology, I explore the transfer pricing of offshored business services through a case study of one of the most commonly offshored business services: teleservices. The typical teleservices TNC (e.g. Convergys, EDS) provides a full range of inbound and outbound call services to third party clients (e.g. Dell, UPS). The firm owns one or more foreign affiliates that deliver call centre services to customers of these third party clients. This article explores the facts and circumstances of this rapidly growing industry and uses economic analysis to develop transfer-pricing rules for the offshored call centres. We compare the methods proposed in the new United States transfer-pricing regulations (IRS, 2003), and discuss the implications for location savings.

2. Offshoring of business services

Although the terms “offshoring” and “outsourcing” are well understood by the international business community (Eden, 2004; UNCTAD, 2004), they are often confused in the public press and elsewhere. Since I use both terms in this article, to avoid any confusion, explicit definitions are provided in table 1. “Outsourcing” is the relocation of one or more stages of production from within the firm to an external party, i.e. the

firm shifts from “make” (cells 1 and 3) to “buy” (cells 2 and 4). When a production stage is moved from inside to outside the firm’s boundaries, its level of vertical integration falls. The externalized production can be sold off to an arm’s length party in the same country as the TNC (the home country) or to an arm’s length party in a foreign country. When the transaction involves a domestic firm, the activity is called “domestic outsourcing”; when the activity involves a foreign firm, the term used is “foreign”, “international” or “cross-border” outsourcing. During the 1990s, many firms attempted to restructure their value chains by outsourcing their low-value stages of production and concentrating on their core, high-value-adding activities.

“Offshoring” is the relocation of one or more stages of production from the home country (cells 1 and 2) to a foreign country (cells 3 and 4). Production can be shifted to a wholly- or partly-owned foreign affiliate in a foreign country (the host country); this is termed “intrafirm or captive offshoring” or, more simply, FDI (cell 3). Production can also be shifted to an arm’s length party in a foreign country, where that firm could be either a domestic firm or another TNC – which can be referred to as “arm’s length or outsourced (external) offshoring”. An outsourced offshored activity is one that has both moved outside the firm (externalized) and outside the home country (internationalized); this is cell 4 in table 1.

Table 1. Comparing in/off-shoring and in/out-sourcing

Location of production		Ownership of production	
		Insourced (internalized)	Outsourced (externalized)
Location of production	Onshore production (home country)	1 Production kept in-house at home	2 Production outsourced to third-parties at home
	Offshore production (foreign country)	3 Production by foreign affiliates in a host country	4 Production outsourced to third-parties abroad

Source: Eden (2004), revision of GAO (2004, p. 58).

Firms have been outsourcing and offshoring manufacturing operations for many years, typically to export processing zones and more recently to China and other developing countries (UNCTAD, 2004). A critical change in the business strategies of OECD-based TNCs over the past five years has been the rapid growth in outsourcing and offshoring of services. White collar, skilled jobs in service industries are now following blue collar jobs in manufacturing, in areas such as basic data entry, telemarketing and claims processing (Mann, 2003; McKinsey, 2003). Large companies are outsourcing both their upstream back office functions and downstream customer relations functions to arm's length services providers (Alvarez, Couto and Disher, 2003; Kearney, 2004; McKinsey, 2003; UNCTAD, 2004).

In addition, business service operations in industries such as telecommunications, transportation and health care, and business process operations such as human resources management, call centres and cheque processing, are moving offshore. Ashok Bardhan and Cynthia Kroll (2003, p. 4) suggest, "Any job that involves mostly '...sitting at a desk, talking on the phone and working on a computer...' is a job under potential threat" of being offshored. They argue that the types of jobs that have been and are likely to be offshored have the following characteristics (ibid, p. 4): no face-to-face customer servicing requirements; high information content; work process is telecommutable and internet enabled; high wage differential with similar occupation in the destination country; low setup barriers; and low social networking requirements. Bardhan and Kroll (2003, p. 6) conclude that the occupations at risk of international outsourcing from the United States include office support, business and financial support, computer and math professionals, paralegals and legal assistants, diagnostic support services and medical transcriptionists, which represent 11% of the United States work force in 2001.

The movement offshore is primarily driven by the location savings that countries like Ireland, Canada and India can offer relative to costs in the United States (Read, 2002; UNCTAD,

2004). Critical factors encouraging offshoring from the United States are cost savings, availability of English-speaking graduates, good information technology (IT) infrastructure, and a favourable Government attitude towards FDI and international trade. In e-services such as call centres, data entry and software engineering, physical proximity is not necessary for efficient and effective delivery. The recent movement to international offshoring of such activities, initially to Canada (e.g. call centres to New Brunswick in the 1990s) and more recently to India, is a new version of the old-style offshoring of low-skilled manufacturing jobs to export processing zones. Scholars now distinguish between “first phase offshoring” when low-skilled manufacturing jobs shifted offshore to developing countries, and “second phase offshoring” of information technology enabled services jobs to countries like Canada and India (UNCTAD, 2004; Dossani and Kenny, 2003, 2004).

How fast is this second phase of offshoring growing? While the actual statistics are difficult to determine,¹ Nobuo Tanaka (2005, p. 23) says that rule-of-thumb estimates suggest that one-third of business services are outsourced and one-third offshored. Thus, captive offshoring (cell 3) represents about 2/9 or 22%, and international outsourcing (cell 4) about 1/9 or 11%, of all business services. Perhaps the fastest growth is occurring in the Indian IT-ITES industry. India’s National Association of Software and Service Companies (NASSCOM) estimates that total revenues of the IT-ITES industry in India grew fivefold over the 1998-2005 period, reaching \$28 billion in 2004-2005, while the IT-ITES share of Indian GDP rose from 1.2% in 1997-1998 to 4.1% in 2004-2005 (<http://www.nasscom.org>).

A.T. Kearney has done an exhaustive study of the factors affecting offshoring across several industries (Kearney, 2004a). The firm repeated this study separately for the IT industry

¹ WTO (2005, pp. 274-284) provides perhaps the best set of summary data on offshoring, collected from several recent industry-level studies and national balance-of-payments statistics.

(Kearney, 2004c) and for business process functions (Kearney, 2004d); the latter is most relevant for the teleservices industry. Offshore locations are evaluated on three factors: cost (40% of the total), environment (30%) and people (30%). Table 2 below amalgamates the 11 country scores from Kearney's BPO report. The order of the columns reflects the overall score for each country. The last two columns of the table report the scores for India and Canada, two key offshore locations for business process services, as a ratio of the average score. These two columns show the areas in which each country is above the average (ratio higher than 1) and below the average (ratio below 1).

The highest country on the list is India with an overall score of 7.3. India ranks first on cost and people, but only seventh on environment. Canada and Mexico are tied with an overall score of 6.2, almost a full point below India. Canada ranks the lowest of the 11 countries on cost, but is first on environment and second on people. Mexico's tied score with Canada is driven by a much better score on cost, but worse performances on environment and people. Immediately behind Canada and Mexico is Brazil, with an overall score of 6.1. This difference is probably not statistically significant, suggesting that Mexico and Brazil are in the same overall category as Canada and should be seen as close competitors. In the next tier are countries clustered in the 5.6 to 5.8 range (Hungary, Ireland, Australia, the Czech Republic, the Philippines, the Russian Federation). China is last with an overall score of 5.2, a significant drop from the previous tier. A.T. Kearney's country comparisons for offshoring in business processing suggest that there are multiple competitors as offshoring locations for United States TNCs.

3. A case study: captive offshoring of teleservices

Since transfer pricing is all about the facts and circumstances of the case, in order to develop useful insights into the appropriate transfer pricing policy for cell 3 in table 1 (captive offshoring), I provide a case study of offshored services in one particular industry rather than examining business services as a whole. *Teleservices* is a new industry that is rapidly

Table 2. Country scores for offshoring business processing functions, 2004
(Numerical scores)

	India	Canada	Mexico	Brazil	Hungary	Ireland	Australia	Czech Rep	Philippines	Russian Federation	China	India /AVG	Canada /AVG
COST (40%)	3.4	1.5	3.0	3.1	3.1	1.8	2.0	3.1	2.9	3.1	3.1	2.74	1.24
COST RANK	1	7	3	2	2	6	5	2	4	2	2		
Labour cost	2.9	0.8	2.2	2.5	2.4	1.0	1.3	2.4	2.5	2.7	2.6	2.12	0.38
MGMT & infrastructure costs	0.2	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.28	0.71
Tax/treasury impact	0.3	0.3	0.4	0.3	0.4	0.5	0.4	0.4	0.2	0.2	0.3	0.34	0.88
ENVIRONMENT (30%)	1.6	2.6	1.9	1.8	1.6	2.5	2.3	1.6	1.7	1.4	1.1	1.83	1.42
ENV RANK	7	1	4	5	7	2	3	7	6	8	9		
Intellectual property	0.3	0.4	0.3	0.3	0.2	0.4	0.4	0.2	0.4	0.3	0.1	0.30	1.33
Geographic proximity	0.2	0.5	0.5	0.4	0.3	0.3	0.2	0.3	0.2	0.3	0.2	0.31	1.62
Cultural compatibility	0.3	0.5	0.3	0.3	0.3	0.4	0.4	0.3	0.3	0.2	0.2	0.32	1.57
Country infrastructure	0.3	0.4	0.2	0.3	0.2	0.5	0.5	0.2	0.3	0.2	0.2	0.30	1.33
Risk (economic, political, government support)	0.5	0.8	0.6	0.5	0.6	0.9	0.8	0.6	0.5	0.4	0.4	0.60	1.33
PEOPLE (30%)	2.3	2.1	1.3	1.2	1.1	1.5	1.4	1.0	1.1	1.1	1.0	1.37	1.53
PEOPLE RANK	1	2	5	6	7	3	4	8	7	7	8		
Employee retention	0.3	0.4	0.4	0.5	0.1	0.2	0.1	0.1	0.2	0.1	0.2	0.24	1.69
Language barriers & literacy rates	0.4	0.5	0.4	0.3	0.4	0.5	0.5	0.4	0.4	0.3	0.2	0.39	1.28
Education level	0.4	0.5	0.1	0.1	0.2	0.3	0.4	0.2	0.1	0.2	0.1	0.24	1.67
Size of labour market	0.4	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.3	0.17	2.35
Outsourcing experience	0.8	0.6	0.2	0.2	0.3	0.4	0.3	0.2	0.3	0.2	0.2	0.34	1.78
TOTAL (100%)	7.3	6.2	6.2	6.1	5.8	5.8	5.7	5.7	5.7	5.6	5.2	5.94	1.23
TOTAL RANK	1	2	2	3	4	4	5	5	5	6	7		

Source: author's calculations, using data from Kearney (2004d, pp. 2, 3, 4, 6 and 8).

setting up captive affiliates offshore.² It may therefore be a bellwether for other business services.

There are two basic types of teleservices: inbound and outbound. Inbound teleservices typically include product service and support, response to customer inquiries and order processing. Outbound teleservices may include direct sales, product inquiry and lead generation and appointment setting. These services are designed to improve the overall customer experience and build closer relationships between companies and their customers. Outbound services are shrinking relative to inbound, as Government “no call” regulations that prohibit firms from making unsolicited calls have spread within the United States.

The typical teleservices TNC provides a full range of inbound and outbound call services to third party clients and owns several affiliates that deliver call centre services to customers of these third party clients. The parent firm’s activities are of two types: support activities, and activities both upstream and downstream from the call centre stage of production. The activities of the call centre affiliates are determined by the teleservices parent firm, with all risks (credit, market, foreign exchange) and responsibilities typically being assumed by the parent firm.

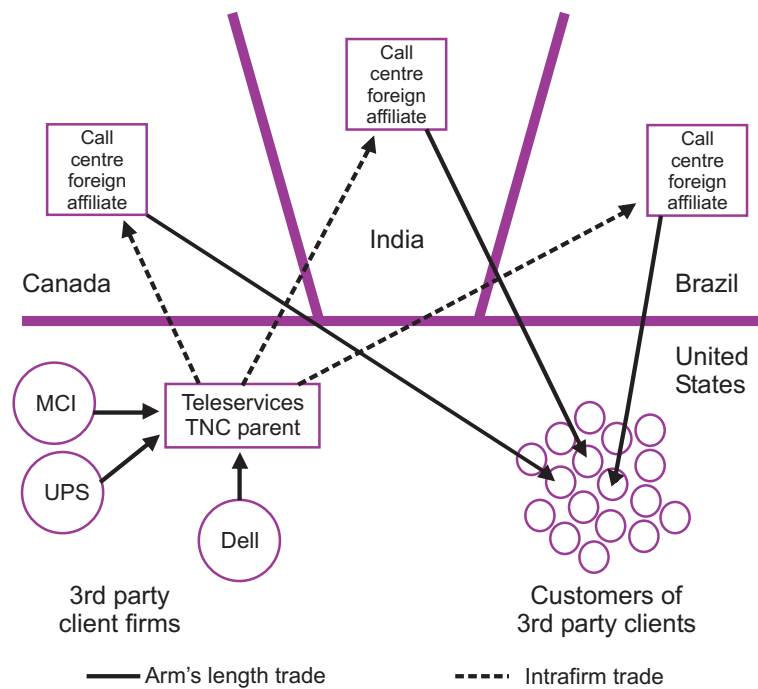
The teleservices industry was created by Fortune 500 firms downsizing and outsourcing their customer relationship management functions, starting in the late 1980s. The industry provides a broad range of customer interface services including service agreement management, internet customer service, warranty management, call centre service, problem/resolution management, customer enquiries, sales channel management, inventory management, and service fulfillment. Mark Plakias (2003) estimates that worldwide revenues in the North American teleservices industry were \$18.5 billion in 2002, of which \$16.9

² For a more detailed analysis of the teleservices industry, see Datamonitor (2003), Gans, Koole and Mandelbaum (2003), 24-7 INtouch (2004), Knowledge@Wharton (2004) and Plakias (2003).

billion were generated by live agents and \$890 million through automated telephone and internet. The top three firms in the industry are Convergys, EDS and Teletch, followed by Teletch, West Corporation, Sitel and Sykes. Teleservices revenues from offshore operations totaled \$3.4 billion in 2002, about 18% of total revenues, which is expected to grow to 25% by 2008 (Plakias, 2003).

An example of a typical teleservices TNC is illustrated in figure 1. Suppose several Fortune 500 firms (Dell, UPS, MCI) decide to outsource their inbound and outbound teleservices activities to one of the big teleservices firms, such as Convergys

Figure 1. Modeling a teleservices TNC



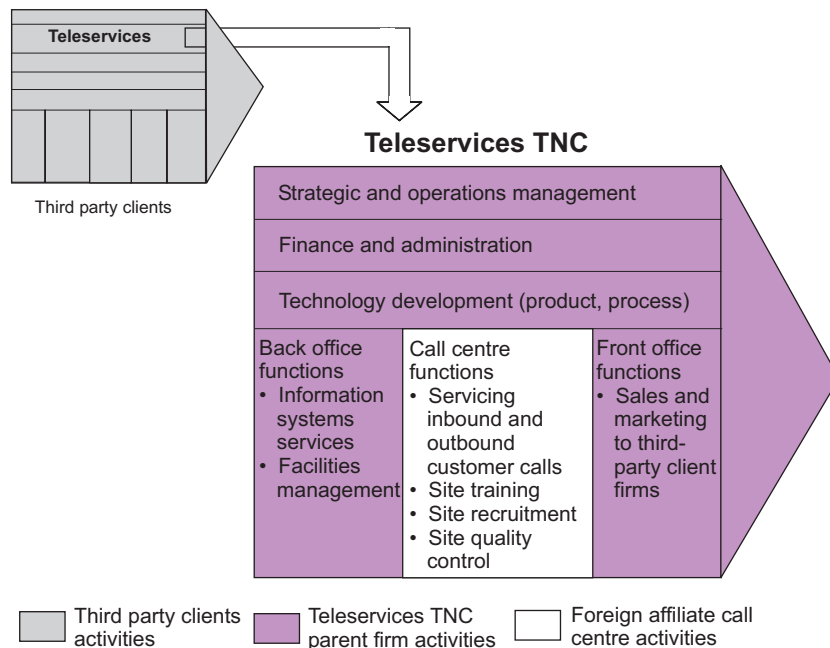
Source: the author.

³ The value chain shows the primary and support activities involved in creating, producing and selling a product to a customer (Eden, 1998). Originally developed by Michael Porter for manufacturing (Porter, 1985), the concept can also be applied to service industries.

or Sitel. What would the activities look like? Figure 1 maps the likely transactions between a teleservices TNC (e.g. Convergys or Sitel) and its third party clients (e.g. Dell, UPS and MCI). The figure assumes that the teleservices firm is performing services that have been outsourced from Dell, UPS and MCI, and that the firm has located all of its call centres offshore, in Canada, India and Brazil. These offshore call centres are responsible for providing inbound and outbound teleservices to customers of MCI, Dell and UPS.

Which activities of the teleservices TNC are performed where? Figure 2 shows the TNC's value chain,³ created by third party clients outsourcing their teleservices function to the TNC. There are two types of value chain activities: support and primary (Porter, 1985). Support activities are provided to the teleservices TNC as a whole. Figure 2 shows three support activities: strategic management (at the corporate and business strategy levels), finance and administration (e.g. all forms of overhead administration and finance, including foreign exchange transactions) and technology development. In terms of technology development, while there may be little R&D done in the teleservices industry, it is clear that firms must either develop their own proprietary software (a production intangible) or purchase it from other firms. In addition, there are in-house process technologies that are also likely to be proprietary but not protected by patents. Teleservices firms, for example, would normally have their own information technology enabled systems involving designing of programmes and scripts, network management, call routing and data retrieval, and quality control. These intangibles are sources of competitive advantage, along with reputation and brand name. Primary activities, for a teleservices provider, are of three types: back office functions that are directly upstream from the call centres (e.g. information systems services provided to the call centres, facilities management), the call centre stage, and front office functions that are downstream from the call centres (e.g. sales and marketing to third party clients). Since the front and back office functions are well understood, I focus on call centres.

Figure 2. Outsourcing of value chain activities to a teleservices TNC



Source: the author.

At the call centre stage, the typical site⁴ has telephone sales representatives and customer service associates handling inbound and outbound “1-800” telephone calls from workstations (Gans, Koole and Mandelbaum, 2003). Some call centres now include not only telephone services but also email, fax, webpages and online chat with customers. A telling description is provided by Gans, Koole and Mandelbaum (2003, p. 3): “The working environment of a large call centre... can be envisioned as an endless room, with numerous open-space cubicles, in which people with earphones sit in front of computer terminals, providing tele-services to phantom customers”. Local management in these centres typically hire, train and supervise

⁴ In manufacturing, an individual location is called a plant; in services, a centre or site.

workers and negotiate contracts with local suppliers of, for example, long distance telephone services, but normally do not have any responsibility vis à vis the overall management of the teleservices TNC as a whole. Since each site would normally focus on providing services to one major client or several smaller clients, local management is also responsible for tailoring services (e.g. in terms of training and quality control) to the demands of third party client firms.

If third party client firms outsource their customer relationship management functions to teleservices firms, do the teleservices firms also outsource parts of their value chains? In particular, is the call centre stage of the teleservices value chain typically in-house or outsourced? I argue that all stages in the teleservices value chain are typically performed in-house, even though one might expect the call centre stage to be outsourced given that it appears to be a low-tech, low-value added stage of the value chain. For example, UNCTAD (2004, p. 151) places call centres in the low-skill services category:⁵

“Low-skill services. These are services with the lowest entry barriers in terms of skills, scale and technology. They include data entry or call centres (although some call centres require higher skills, computer or technical support). They tend to need general – but not very high – levels of formal education, a working knowledge of the relevant language and/or basic computer skills. There are generally few economies of scale or agglomeration: a call centre may be viable with 30

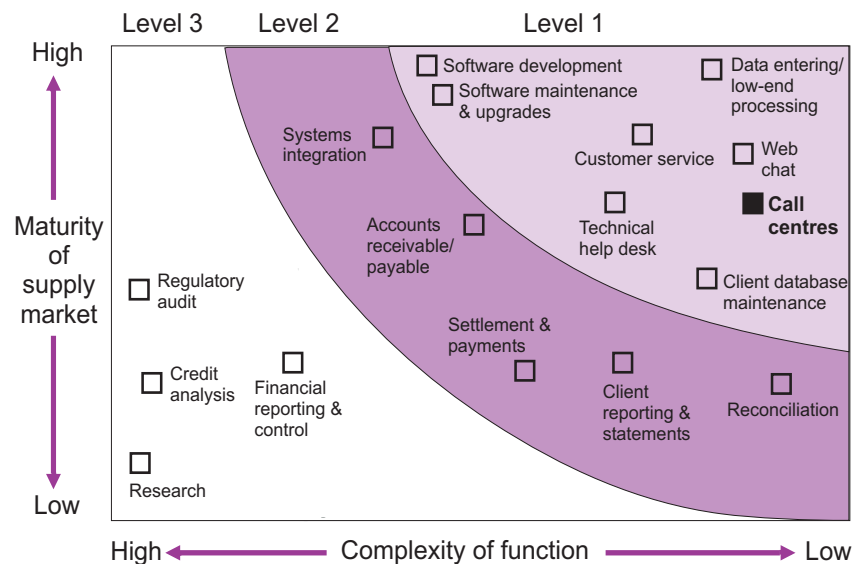
⁵ UNCTAD (2004, p. 151) states, “medium-skill services...are complex services that require more advanced skills, and may offer considerable scale economies and agglomeration effects. Examples include financial and accounting services, standardized programming work, routine data analysis and processing or back-office services such as ticketing and billing. Specialized training would generally be required (and so also the necessary training institutions). The building of competitive capabilities may also call for a large local market where the skills accumulate over time. Some services may require a minimum critical mass of different skills in one location to provide the whole package.” Call centres clearly cannot be considered medium-skilled services.

operatives in a site where there are no similar centres or knowledge institutions. The level of development of other services or manufacturing is not necessarily important for competitiveness in such activities. For this reason, there are likely to be few positive spillovers in terms of supplier linkages or skills creation.”

Figure 3 below, adapted from A.T. Kearney (2004b), illustrates this point by comparing the maturity and complexity of offshore information technology and business process services. Level 1 services have low functional complexity and high maturity of the supply market (that is, a high degree of competition). Call centres (the black square), web chat and data entry are examples of level 1 services.

Why are call centres typically not outsourced? I hypothesize that, despite their low-level of complexity and skill, quality control of call centres is a critical factor in the overall

Figure 3. Maturity and complexity of offshore IT and business process services



Source: author’s interpretation of Kearney (2004b).

success of a teleservices firm.⁶ Mark Casson (1982) argued that the high transaction costs associated with ensuring quality control of arm's length suppliers were the major reason for vertical integration in perishable fruit industries such as bananas. According to internalization theory, the greater the need for quality control, the more likely that the activity is internalized within a TNC. A reputation for high quality enabled firms like Dole and Chiquita to charge significantly more for perishable fruit, thus making insourcing profitable. Quality control has also been a critical factor in determining which functions manufacturing firms have kept in-house rather than outsourced. Similarly, I argue that in business services such as teleservices, brand reputation is based on a firm's ability to deliver consistently high-quality services. The need to monitor for quality requires insourcing of the teleservices firm's activities, including the low-skilled call centre stage – i.e. third party clients are willing to outsource their inbound and outbound call activities if the teleservices firm can guarantee a high-quality product tailored to the needs of the specific client. This means the call centre stage must be internalized within the teleservices firm.

A related issue is the level of general services provided at the call centre stage of production. 24-7 INtouch (2004, p. 3) separates call centre activities into three levels. Level 1 includes straightforward (several minutes in length) telephone calls that can be answered through simple queries, scripts, or frequently asked question lists and only require basic product knowledge. Level 2 includes longer (several minutes to several hours in length) telephone calls involving detailed questions that require significant depth of knowledge to answer. Level 3 includes very long (several hours to day long) calls that require multiple

⁶ Service quality can be measured in several ways (Gans, Koole and Mandelbaum, 2003, p. 12): (1) accessibility of agents (How long did the wait time on the telephone before speaking to an agent? How many callers abandoned the queue before reaching an agent?); (2) service effectiveness (Was the customer's problem resolved or was additional work required?); (3) content of the agent-customer interaction (Did the agent manage the conversation flow in the prescribed manner?); and (4) output of the interaction (Was the customer satisfied?).

people, multiple systems and an expert level of product knowledge.

Now I turn to analyzing which stage or stages of the teleservices value chain have been offshored, and why and where they have gone. Typically, it is only the call centre stage of the value chain that has been offshored to a foreign affiliate (Gans, Koole and Mandelbaum, 2003; A.T. Kearney, 2004c; Plakias, 2003), with the other stages performed by the TNC parent in the home country (shaded in purple in figure 2). Since most of the TNCs in this industry are United States firms, this suggests that the teleservices industry today consists of United States parent firms performing the purple-shaded functions and their wholly-owned foreign affiliates performing the call centre stage of the value chain.

UNCTAD (2004, p. 158) notes that, “In the call centre industry, the largest contract services providers include Convergys, ITC Group, Sitel and Sykes – all from the United States”. These firms have call centres in Argentina, Brazil, Canada, Colombia, India, Indonesia, Jamaica, Mexico, Morocco, Panama, the Philippines, the Republic of Korea, Singapore, Sri Lanka, Taiwan Province of China and Thailand – a veritable “alphabet soup” of economies. *WIR04* (ibid., p. 161) also states: “more than half the 500 FDI projects in call centres recorded in 2002 and 2003 went to developed countries, notably Canada, Ireland and the United Kingdom”; but the “preferred locations for call centres in the near future include India, the Philippines, China, South Africa, Mauritius and the United Arab Emirates”. Table 3 below shows the country distribution of new call centre FDI projects in 2002-2003.

What are the main factors attracting call centres to particular locations? UNCTAD (2004, p. 161) argues that “geographical and psychic distance to markets matters, as do linguistic, cultural and other affinities – and that costs are not the only determining factor”. *WIR04* states that labour costs account for 50-70% of total costs for call centres located in developed countries (e.g. Canada, Ireland), and that cost savings

in the range of 30-40% can be achieved by moving to India (ibid., p. 165). However, cost savings are not the only factor determining FDI location. Quality of services, quality of telecommunications infrastructure, availability of labour skills, language skills, staff attrition and turnover, cultural affinity, and the time zone also matter. Moreover, Government policies – in particular, location subsidies – can be important when choosing between otherwise similar locations.

Therefore, the call centre stage of the value chain for the teleservices industry tends to be insourced and offshored (cell 3 in table 1). By wholly owning this stage of the value chain, a teleservices TNC can enforce similar quality and standards of performance across all its call centres. A TNC can monitor performance and ensure that the needs of third party clients are met at a consistently high level of quality – economies of scale and scope can be exploited at the firm level. By locating the call centres overseas, a teleservices TNC benefits from abundant semi-skilled labour and good ITES infrastructure in countries such as India and the Philippines.

I now turn to an economic analysis of transfer pricing in this industry, based on the facts and circumstances presented above.

Table 3. Export-oriented FDI projects in call centres, 2002-2003
(Number and percentage share)

Country	No of FDI projects	% share of FDI projects
Canada	56	11
European Union	169	33
United States	15	3
All developed countries	279	54
China	30	6
India	60	12
Philippines	12	2
Singapore	16	3
All developing countries	203	40
Central and Eastern Europe	31	6
World	513	100

Source: UNCTAD (2004, p. 162).

4. Transfer pricing of teleservices in theory

Firms in the teleservices industry are vertically integrated TNCs where the upstream stage provides the full range of teleservices (the parent firm) and the downstream stage (the affiliates) provide call centre services. Moreover, these TNCs are also horizontally integrated since there are several call centres, all offering basically the same or similar services (inbound and outbound call activities) to the same or similar customers (customers of third party clients). As such, I can apply traditional microeconomic theory of the TNC (Eden, 1998) to analyze a firm's activities.

I assume, for simplicity, that a teleservices TNC consists of a parent firm (PAR) located in the United States and two wholly-owned call centre affiliates, one in the home country (USCO) and one in Canada (CANCO), both providing identical services to customers of the third party clients.⁷ The TNC parent is assumed to have some price setting ability in terms of its negotiations with third party firms, and therefore its demand curve, D_{PAR} , is downward sloping. D_{PAR} shows the actual price paid by third party clients for the services provided by the TNC's affiliates. For simplicity, I assume that all third party clients are charged the same price per unit of service, P_X , regardless of which call centre provides the services and the nature of the services provided.⁸ The volume of these services, X , equals the sum of the services provided by each of its call centres, i.e. $X = X_{US} + X_{CA}$. Thus, total revenues received by the TNC equal the revenues generated by the call centres, i.e. total revenues equal $P_X (X_{US} + X_{CA})$.

From previous work on this topic (Eden, 1998), for profit maximization (ignoring tariffs, corporate taxes and other market

⁷ I assume one affiliate is located in the home country in order to explore location savings (see below).

⁸ Obviously, a more sophisticated analysis would incorporate differential pricing for different types of services provided to different clients from different locations, which would be the norm in practice. This complication is ignored here because the extension is straightforward.

barriers), a vertically and horizontally integrated TNC will set:

$$MR_{PAR} - MC_{PAR} = NMR_{PAR} = MC_{US} = MC_{CA} = p \quad (1)$$

where $MR_{PAR} - MC_{PAR}$ is the net marginal revenue (NMR_{PAR}) that the parent firm receives on its own activities, i.e. NMR_{PAR} equals the marginal revenues that the TNC parent receives from third party clients, MR_{PAR} , minus the costs of its own activities, MC_{PAR} (management, marketing, business services, process technology development, and so on). Because the TNC is vertically integrated, it maximizes profit by equating the net marginal revenues from the parent firm's activities to the marginal cost of each foreign affiliate's activities; i.e. $NMR_{PAR} = MC_i$ (where $i = US$ or CA). Note that the parent firm's activities can be either upstream or downstream from foreign affiliates activities. Because the TNC is horizontally integrated, it allocates production between the sites such that the marginal cost of production is the same across all the call centres; i.e. $MC_{US} = MC_{CA}$. Putting these two requirements for profit maximization together gives us equation (1).

The efficient transfer price p is the Lagrangian on the constraint that all output is sold (Eden, 1998). This is the opportunity cost of producing Q_x . In the absence of an external market price, the efficient transfer price is the transfer price that equates NMR_{PAR} to the marginal cost of each of the affiliates. Thus, each affiliate receives a transfer price that just covers its marginal production costs. This price is clearly lower than the price charged by the TNC to third party clients, P_x , because that price must cover not only the call centres' expenses but also those of the parent firm. The efficient transfer price is also the profit-maximizing transfer price in the absence of an external market price in a world without tariffs and nontariff barriers (Eden, 1998). However, if an external market does exist for this product (i.e. if there are other producers of call centre services willing and able to supply this market), then the Hirshleifer Rule (Eden, 1998) says that, barring interdependencies, the efficient (and profit-maximizing) transfer price is the external, or arm's length, market price.

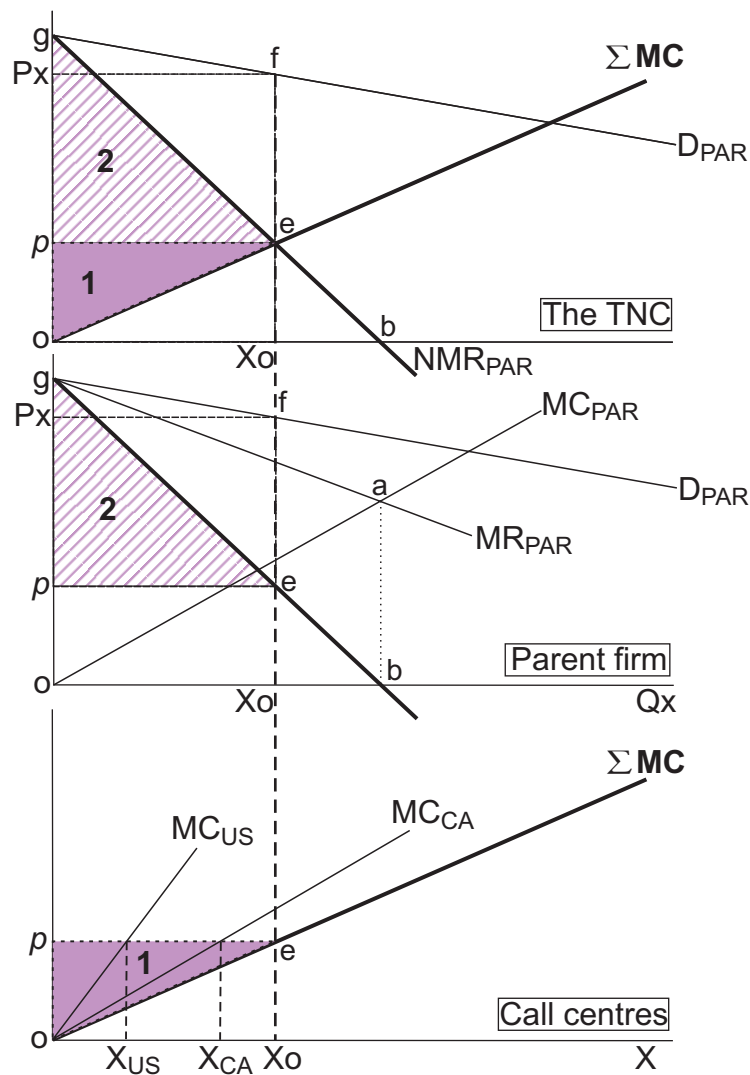
The above arguments are illustrated in figure 4, which consists of three graphs. All three graphs have the same vertical axis (price) and horizontal axis (quantity). Starting in the middle graph, with the TNC parent firm, the net marginal revenue (NMR_{PAR}) is the vertical distance between the MR_{PAR} and MC_{PAR} curves. Thus, NMR_{PAR} intersects the horizontal axis at point b, which is directly below the point at which $MR_{PAR} = MC_{PAR}$. The net marginal revenue curve is then plotted in the top graph. The bottom graph shows the marginal cost curves for the two call centres, with MC_{US} being higher than MC_{CA} reflecting the assumed lower costs of production in Canada than in the United States. The two marginal cost curves are horizontally summed as the ΣMC curve; this curve is reproduced in the top graph. The point at which ΣMC intersects NMR_{PAR} satisfies equation (1) and maximizes profits for the TNC as a whole. This is point e with output X_0 in total, X_{US} from the United States site and X_{CA} from the Canadian site.

The efficient transfer price is p (directly across from point e) and the arm's length price to the third party clients is P_x (point f on the demand curve, which is directly above point e). The transfer price p divides the total profit of the TNC between the two call centres and the parent firm. Total profit (in the absence of fixed costs, which would have to be deducted here) is measured by triangle Oge in the top graph (the area under the net marginal revenue curve for the parent firm and over the summed marginal cost curve for the affiliates). Total profit is therefore the sum of area 2 (which goes to the parent firm) and area 1 (which is split between the two affiliates depending on their cost curves; the affiliate with the lower cost receives a higher share of the profits). Area 2 (the parent firm's profit) is shown in the top two graphs, and area 1 (the affiliates' profits) in the top and bottom graphs.

It should be clear from the graph that the transfer price, and therefore the split in profits, is determined by the elasticity of the NMR_{PAR} and ΣMC curves. Making either curve flatter or steeper shifts the allocation of profits. For example, the more elastic (flatter) is NMR_{PAR} , the smaller is area 2. Elasticity is

primarily driven by the availability of substitutes and degree of competition in the marketplace (and by time, since elasticity rises over time as the availability of substitutes increases and contracts can be rewritten). Thus, the better the substitutes, and

Figure 4. Profit maximization by a teleservices TNC



Source: the author.

the greater the degree of competition the TNC faces in the output market for teleservices, the more elastic NMR_{PAR} will be and the smaller will be area 2.

Similarly, the more elastic is the ΣMC curve, the smaller is area 1. The elasticity of the call centres' supply (marginal cost) curves depends primarily on the costs incurred in purchasing factor inputs, primarily labour costs. The better the substitutes and the greater the degree of competition in factor and input markets in each of the call centre locations, the flatter will be the marginal cost curves for the affiliates, and the smaller will be area 1. Since call centres are a labour-intensive activity and are typically located in areas where labour costs are low and low skilled labor is in plentiful supply, marginal cost curves for call centres should be relatively elastic. Moreover, because the skill level of labour is not high (Grade 12 education plus training), closing down a site to shift production to a lower cost location is relatively easy activity in this industry compared to, for example, a manufacturing industry like automobiles. This also increases the elasticity of the marginal cost curve, particularly over the longer term when capital mobility is high.⁹

I have assumed so far that there are no other arm's length suppliers of call centre services in the places in which the TNC's affiliates are located. If an external market in call centre services exists, the TNC could simply have contracted out for these services to an arm's length provider. The Hirshleifer Rule (Eden, 1998) says that, if an arm's length price exists, a profit maximizing TNC will accept this price as the efficient (and profit maximizing) transfer price. This market price, called the comparable uncontrolled price (CUP), may arise in one of two ways: either from transactions between other unrelated firms in

⁹ Changes in the business environment can affect a TNC's decision-making and profitability. If costs should change between the sites (e.g. the value of the Canadian dollar falls, causing MC_{CA} to shift downwards relative to MC_{US}), the TNC will shift production from the higher to the lower cost site. This would cause a downward shift in MC_{CA} , for example, which would then cause the summed marginal cost curve to shift to the right, intersecting the NMR_{PAR} curve somewhere between points e and b. The TNC would expand production and the transfer price would fall.

the open marketplace (called an “external comparable”), or from the teleservices TNC transacting (either selling or buying) the same service under the same circumstances with one or more unrelated firms (called an “internal comparable”). Internal comparables are normally preferred to external comparables because comparability is expected to be higher (Eden, 1998).

Hirshleifer’s Rule normally applies, except where (1) the service provided by independent firms is not comparable with the related party service (note, however, that, if differences are minor, or can be quantified, the transfer price can be adjusted for these differences under the OECD transfer-pricing guidelines) and/or (2) there are interdependencies on the supply or demand side that are not taken into account by the external market price (such as intrafirm economies of scale or scope or other synergies that accrue to related parties). In these situations, the external market price is neither economically efficient nor profit maximizing, although it may be the best available price and therefore selected because it is administratively feasible (Diewert, Alterman and Eden, forthcoming).

5. Transfer pricing of teleservices in practice

Moving from economic theory to current practice: what is the appropriate transfer pricing methodology for a TNC to use in intrafirm transactions with its foreign affiliates, viewed from both the TNC and Government perspectives? Two sets of Government regulations come into play here: the home country’s regulations, which apply to the TNC’s overall corporate profits, and the host Government’s regulations, which apply to its foreign affiliates. Both Governments probably adhere to the arm’s length standard under the OECD transfer-pricing guidelines (OECD, 1995), but there are often differences between national regulations. Moreover, where more than one transfer pricing method can be used in a particular situation, each Government is likely to choose the method that shifts income into its jurisdiction and therefore makes it taxable. This causes tax disputes between Governments, where the TNC is caught in the middle (Eden, 2001).

The OECD transfer-pricing guidelines were developed for a world in which intrafirm transactions typically involved manufactured goods and natural resources. As a result, the rules for intrafirm transactions in services are much less developed than for raw materials and intermediate and finished goods. The original OECD guidelines allowed payment for intrafirm services only if a real benefit was actually received by the foreign affiliate that was charged for the service (OECD, 1979). In effect, the benefit-cost principle, applied to the individual TNC subunit, was used to determine the arm's length price for services (Eden, 1998; Liebman and De Boeck, 1988). A mark-up over costs could be included if provision of the service was the related party's primary activity; in all other cases, no profit element was permitted.

The current guidelines (OECD, 1995) are short (14 pages) and follow the outline laid down in OECD (1979). The guidelines recommend that services provided to a TNC group as a whole (for example, group purchasing) use indirect charge methods with an allocation key (e.g. sales, turnover, employment). The guidelines note that services are often difficult to untangle from intangible assets, compounding the pricing difficulties since intangibles are notoriously difficult to value (Boos, 2003; Eden, 1998).

Still, compared to the detailed methodologies developed for intrafirm transactions in goods, the transfer pricing of services has received much less attention from regulators. Until recently, the United States Internal Revenue Service (IRS) section 482 regulations on services had little changed since they were developed in 1968. These regulations require the arm's length price for intragroup services to be the amount that was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances, considering the relevant facts and circumstances of the transaction. Moreover, "the body of law applicable to the transfer pricing of services is quite small" (Feinschreiber, 2004, p. 138). Despite (or perhaps because

of) the lack of detailed regulations, Ernst & Young (2003, p. 17), in its biennial survey of TNC transfer-pricing policies, found that three-quarters of its respondents used some form of cost-based pricing to value intrafirm transfers of services, and another 20% used external market-based prices.

That has now changed since the IRS and the United States Treasury issued proposed new regulations for intercompany services (IRS, 2003). The proposed regulations follow the existing set of methods for pricing intrafirm transactions in goods (IRS, 1994), but adapt them to services and to services bundled with intangibles. TNCs are to select the best method based on comparability of functions performed, risks assumed, contractual terms, economic conditions, and the nature of the property or service. The core methods are the comparable uncontrolled services price (CUSP), which is based on the comparable uncontrolled price method; the gross services margin method based on the resale price method; the cost of services plus method based on the cost plus method; and versions of the comparable profit method and the profit split method that replace their goods counterparts. A simplified cost-based method is provided for “routine back-office functions” considered “low-margin services”. The application of the arm’s length standard to intrafirm transactions in services therefore depends on finding internal or external comparables to the intragroup services. The reaction to the proposed regulations has been generally favourable, although opinions differ (see, for example, Anwar *et al.*, 2004; Lewis, 2003; Ossi *et al.*, 2003; Warner, 2004; Zollo, Bowers and Cowan, 2004).

Since United States transfer pricing practice has typically been a bellwether for other countries’ legislation in this area (Eden, 2000; Eden, Dacin and Wan, 2001), the proposed IRS regulations are being closely watched by other Governments. Applying each of the proposed transfer pricing methods to my teleservices TNC case should therefore provide a useful test of the applicability of the proposed regulations for offshored business services.

A. *CUSP or CUP*

For goods transactions, Government tax authorities prefer the use of the CUP method to other methods, when there exists either an exact (fully comparable) CUP or an inexact CUP with quantifiable differences in functions, assets and risks. The CUSP method follows the same logic, looking for a comparable arm's length transaction in business services. If I apply the CUP/CUSP method to my case study, there may be a few possible CUPs at the call centre stage of the teleservices value chain. First, the call centre affiliates may be selling call centre services (inbound and outbound transactions) on an external market, and if the transactions exist and are sufficiently similar in type, size and market characteristics, this external price could be considered an internal comparable, suitable for a CUP. Second, there may be available contractual providers of call centre services willing to contract with the parent firm to provide only call centre activities. A third possibility would be to look at contractual providers of call centre activities (if such firms exist) in another country in which there is public information available, and attempt to quantify the geographic market differences.

As I have argued above, however, quality control issues and the need to tailor activities closely to the demands of third party clients, have led teleservices TNCs to internalize the call centre stage of the value chain; thus, there are not many external firms offering to contract for these services. As a result, an external market in call centre services does not exist, and none of these approaches to determining a CUP appears to be likely. To the extent that teleservices TNCs all insource their call centre activities, there are no exact or inexact arm's length prices.

Interestingly, there are CUPs, but not at the call centre stage. Each contract between a teleservices TNC and a third party client is a CUP, so each teleservices TNC will have several CUPs. Moreover, the teleservices industry is competitive, with large numbers of both suppliers and buyers (Plakias, 2003), so that there are also multiple good arm's length prices available for the teleservices industry as a whole. However, this CUP represents all the costs of the services provided by a TNC to its

clients, not just the services at the call centre stage, and therefore rewards all the functions performed, intangibles held and risks borne by a TNC as a whole. It is therefore an inappropriate transfer price.

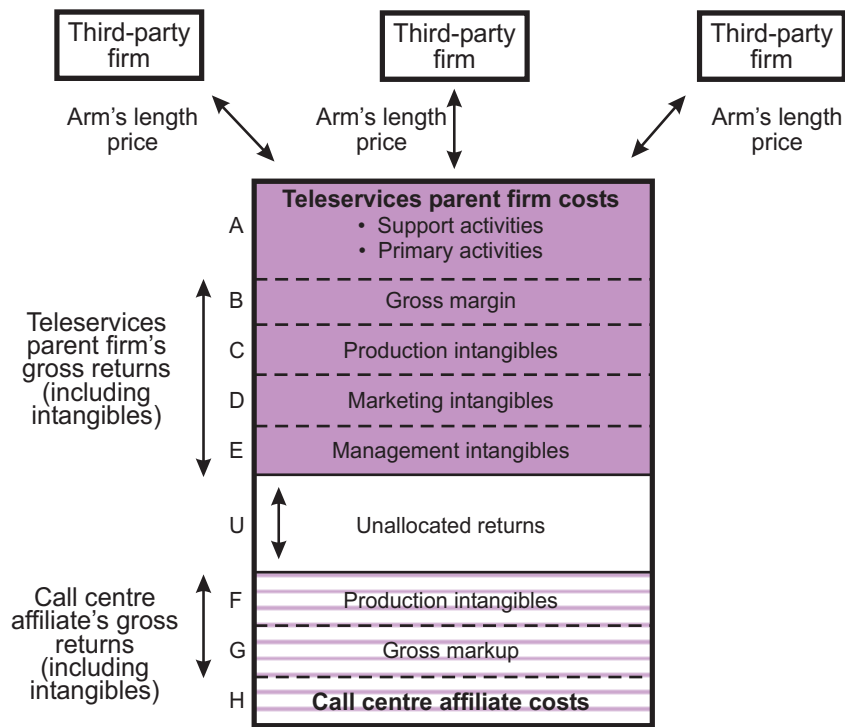
The problem is illustrated in figure 5 below, which shows a teleservices parent firm undertaking the activities outlined in the value chain (figure 3), its call centre foreign affiliate, and their third party clients. The parent firm undertakes the functions, assets and risks associated with box A (parent costs) on which it earns a gross margin (area B) commensurate with other teleservices firms in the industry. In addition, the parent firm owns production intangibles (area C) based on process and/or product technologies that it has developed through in-house capabilities. These may or may not be protected by patents. The firm also owns marketing intangibles, such as its brand name and reputation (box D). Another possibility, if the firm has superior management routines developed over time that are tacit in nature, is management intangibles (box E).¹⁰ From the call centre perspective, the call centre has its own production costs associated with its functions, assets and possibly some risks (box H), and should therefore earn a gross markup commensurate with what other call centres are receiving (area G). The call centre may also have some production intangibles associated with superior quality production, process technologies developed in-house at the foreign affiliate level, and so on. These may or may not be patented.¹¹

The transfer pricing issue is to split the total (boxes A through H) between the parent TNC and its call centre affiliates. The problem is that there are no CUPs for valuing the call centre's activities. There are CUPs that can be used to value the *sum* of boxes A through H, but not to *split* the profit between the teleservices parent firm and its affiliates.

¹⁰ For a recent analysis of intangibles from a transfer pricing perspective, see Przysuski, Lalapet and Swaneveld (2004).

¹¹ The OECD transfer-pricing guidelines refer to these as manufacturing intangibles, which seems an inappropriate term for a service provider; so I use production intangibles (a more general term).

Figure 5. The transfer pricing problem for a teleservices TNC



Source: the author.

B. Gross services margin method or resale price method

The fact that the only CUPs are likely to be the prices negotiated by teleservices TNCs and their third party clients suggests that one method for determining the arm's length price might be to use the resale price method, renamed the gross services margin method in IRS (2003). In the resale price method, the distributor is designated as the tested party, and a gross profit margin is allocated to the affiliate based on the gross margins earned by distributors providing comparable functions to the tested party. The residual return goes to the other related party. The economic intuition behind the resale price method is to ask what a manufacturer would have to pay to outsource the

distribution function to a contract distributor. Applying this to our call centre case, the “manufacturer” is the call centre affiliate and the “distributor” the TNC parent firm. One therefore need to determine the gross margin that the call centre affiliate would have to pay to an independent contractor for the sales and marketing activities needed to market the call centre activities to third party clients.

Clearly, there are serious difficulties in implementing this method. First, the resale price method works best when the tested party has few or no intangible assets (Eden, 1998). The equivalent would be to assume that the parent teleservices firm’s activities in figure 5 involve only area A so that all that must be valued is the gross margin (area B). However, as I argued above, the value chain of a typical teleservices TNC places all the core activities with the parent firm (the shaded areas in figure 2). Thus, the parent firm is the only unit with significant intangibles and the resale price method is inappropriate.

Moreover, there is a second problem that affects both the resale price method and the cost plus method because they each focus only on one side of the transaction. Because of the continuum price problem, one-sided methods lead to quite different splits of the profits between the related parties: the resale price method shifts the unallocated profits to the upstream manufacturer; the cost plus method shifts the unallocated profits to the downstream distributor (Eden, 1998). The proposed 2003 United States transfer-pricing regulations for intragroup services do not solve this problem. Allocating a market-based return to a manufacturing unit (in this case, the call centre foreign affiliate) and a market-based return to the distributor (in this case, the parent firm), typically leaves an unallocated amount of profit (area U) between the related parties. This can occur even after accounting for all known and measurable intangibles. The “leftover profit” occurs because each method is one-sided, looking only from the perspective of one party to the transaction and treating it as a contractual provider of services. The resale price method treats the parent firm as a contractual provider of teleservices to the call centre, and allocates all residual profits to the call centre stage of production. The cost plus method, on

the other hand, treats the call centre as a contractual provider of call centre services, and allocates all residual profits to the parent firm.

C. Cost of services plus or cost plus method

A third possibility is the cost plus method. Since call centres are in the business of providing incoming and outgoing call services, one can expect that a profit margin is attached to their activities (OECD, 1995). The affiliates would not price their services at cost. The call centre stage is a service provider that should be rewarded with a gross margin based on its functions performed, assets (real and intangible) owned,¹² and risks assumed. The gross margin should not be large since this activity is not sophisticated and the typical call centre assumes little risk and owns few intangibles.

From the perspective of a TNC parent firm, the question is what gross markup the TNC would have to pay an arm's length contractor to provide the call centre stage of the value chain rather than use its own in-house affiliates. If there is an external market with several possible outside suppliers of call centre services, the opportunity cost to the TNC of an in-house supplier is the markup over costs that would be charged by an arm's length call centre. While the cost plus method (cost of services plus method), like the resale price method, suffers from the continuum price problem, this is much less problematic in teleservices because the call centre stage has few intangibles attached. Moreover, the call centre is the appropriate tested party since it has the simplest activities with the least intangibles. The key issue is determining the appropriate gross markup. The simplified cost-based method (IRS, 2003), which is intended for low-end offshored business processes, might well apply to this situation, which would limit the gross return to a maximum of 10%.

¹² A major transfer-pricing controversy has been who should receive the rents from intangible assets when the developer and the owner are related but different parties (Przysuski, Lalapet and Swaneveld, 2004). IRS (2003) attempts to solve this problem for services with intangibles. I do not address this issue here.

Since call centres are typically in-house operations, it is impossible to use transfer-pricing resources, such as COMPUSTAT or WORLDSCOPE, for example, to determine a gross markup for comparable service providers.¹³ The only metric available would be the gross margins of other teleservices TNCs, defeating the purpose of allocating profits between a parent firm and its foreign affiliate.

Another possibility might be to focus on the comparability of functions, in terms of the quality of labour services and technological sophistication, as illustrated in figure 3. Web chat, client database management and data entry all share the same low level of complexity of functions as do call centres, although they vary in terms of market maturity. To the extent that arm's length suppliers exist for these services, their gross markups might provide a benchmark for comparison purposes with call centres.

Under the cost plus method, all remaining returns would be allocated to the parent firm. In terms of figure 5, the parent firm receives its normal return for the functions, assets and risks on behalf of its foreign affiliate (areas A + B + C + D + E) plus any residual profits (area U); the call centre foreign affiliate receives its normal return for its functions, assets and risks (areas F + G + H).

D. Other methods

Another possibility is to use the comparable profits method (CPM) or its "OECD cousin", the transactional net margin method (TNMM). Under CPM and TNMM, one of the two related parties (either the seller or the buyer) is designated as the tested party. A net return is allocated to the tested party based on average returns earned by unrelated firms on comparable transactions or functions. Unallocated profits are then assigned to the other related party. In the teleservices case, the tested

¹³ See Eden and Smith (2001) for an analysis of the availability and quality of transfer pricing resources.

party should be the call centre unit because it has the fewest and the simplest functions. CPM and TNMM, however, suffer from the same problems as the gross margin methods: a one-sided method and a lack of arm's length firms providing similar services. Moreover, CPM (and to a lesser extent, TNMM) “uses *industry-wide* rates of return to value the activities of *individual affiliates* of a multinational enterprise as they transact in *specific products*” (Eden, 1998, p. 625). This encourages simplistic, formulaic and misleading applications of the arm's length standard that ignore the facts and circumstances of these transactions. Thus, we do not expect CPM or TNMM to be very useful for transfer pricing of teleservices.

Profit splits are the last method considered here. Under the residual profit split (similar to the old BALRM, basic arm's length rate of return method), both parties would be given a normal return (using either a gross margin method or TNMM) for their own activities, and then a valuation is placed on each of their intangibles. However, that still leaves a remainder (area U in figure 5) to be allocated between a parent firm and its foreign affiliate, which I argue belongs to the parent firm. Few call centre affiliates own and/or have developed intangible assets of their own (area F) and, therefore, a residual profit split seems an extraordinary amount of work here. A residual profit split would involve having to put an arm's length valuation on each of the intangibles held by the parent firm, a tricky business at best, in addition to valuing the primary activities performed by each party and the support activities performed by the parent firm. This is far more effort than would be involved in the cost plus method. However, for offshored business services that are knowledge-intensive services (level 3 services in figure 3), the residual profit split is probably the best approach.

6. Additional complications

A. Three-tiered TNC structures

I have assumed so far that the TNC consists of a parent firm and one or more call centres, providing arm's length teleservices to third party clients. A second possibility is a two-

tier structure whereby a Fortune 500 firm sets up its own foreign affiliate to provide offshored business services (possibly in a tax haven) and the first-tier affiliate sets up one or more second-tier affiliates elsewhere (low-labour cost countries) to perform these offshored services. For example, suppose Dell Computers established a teleservices affiliate (“TeleDell”) in the Cayman Islands to provide teleservices for all its affiliates worldwide, and TeleDell sets up a call centre in India (“CallDell”). In this situation, transfer prices must be determined for the intrafirm transactions between Dell and TeleDell and between TeleDell and CallDell. The cost plus method should continue to be the best method for pricing the call centre stage of the value chain. Since there are many independent suppliers of teleservices, it should also be possible to calculate an arm’s length transfer price between Dell and TeleDell by using either internal or external comparables to value TeleDell’s functions, risks and assets. Still, the complications are clearly greater. Moreover, as the number of offshored locations rises, so does the number of Governments involved in regulating these intrafirm transactions, increasing the benefits from a coordinated, multi-Government approach such as a Multilateral Advanced Pricing Agreement (MAPA).

B. Location savings

The primary motivation for offshoring business services is the potential location savings of moving from a high-cost to a low-cost location. A key transfer pricing issue is therefore likely to be the question of location savings, and their allocation (if the savings exist) between a parent firm and its foreign affiliates (and, thus, between the tax authorities in the home and host countries). Location savings are the “cost savings that an MNC realizes as a result of locating from a high-cost to a low-cost jurisdiction” (Allen *et al.*, 2004, p. 158) or, more succinctly, “the cost savings from operating in a cheaper location” (Eden, 1998, p. 245).

The location savings from moving business services offshore can be substantial. Rafiq Dossani and Martin Kenny (2004, p. 49) compare the cost of a typical call centre in Mumbai, India, with one in Kansas City, United States. They find costs

per hour of \$2.08 in India, compared to \$10.39 in the United States, for a location savings of \$8.31 per hour.

Location savings become a transfer pricing issue when the foreign site is owned or controlled by a TNC since the transfer price determines how much of the location savings remain with the call centre in the host country compared to the parent firm in the home country. Thinking about location savings from a transfer pricing perspective suggests several extensions. First, location savings apply to an affiliate owned or controlled by a TNC where the affiliate produces outside its home country. Second, location savings are relative measures as they are defined for one particular location relative to another. This means that the location must be defined as specifically as possible since the measure applies to a particular producer in a particular location at a particular point in time. A different producer in the same location at the same point in time could well produce at a higher or lower cost. A different location within the same host country could also easily involve different amounts of cost savings. In addition, the cost savings could easily vary over time as, for example, wage rates or productivity levels change. Moreover, the two locations do not have to be the home and host locations, but could involve two host countries (e.g. Canada, India), where the issue is the amount of cost savings from relocating from one host location to another.

Third, location savings are measured as net savings since most locations involve some costs that are lower and others that are higher, when two jurisdictions are compared. Labour costs may be lower in location X, but energy costs lower in location Y. Therefore, net savings must be computed between the two locations. Fourth, exchange rates matter in determining location savings since these must be measured in a common currency. Most TNCs probably use the local currency in their affiliates, and consolidate financial statements on an annual basis in their home currencies. Who bears the foreign exchange risk therefore becomes an issue in determining the arm's length transfer price.

Fifth, location savings ignore the revenue side of the balance sheet and concentrate only on the difference in

production costs in the two locations. However, revenues can also vary between locations. Microeconomic theory (Eden, 1998) tells us that a TNC allocates production between two locations based on their relative marginal costs, and allocates sales between two locations based on their relative marginal revenues. Therefore, the volume of intrafirm transactions is affected by both marginal costs and marginal revenues. This implies that, because all firms (including TNCs) respond to price signals, the volumes of production and sales are likely to be different in the two locations. It is therefore important to distinguish between location savings measured on an *ex ante* or *ex post* basis.

The *ex ante* calculation of location savings involves asking how much a TNC would save simply from the drop in costs, holding all other things constant (production levels, factor intensity, product price). In effect, the *ex ante* calculation measures the location savings from the original location's perspective. For example, assume production currently takes place in the United States by the United States parent firm and that the parent firm shifts production to Canada, creating a new foreign affiliate. The *ex ante* calculation of location savings is based on the parent firm's point of view (assuming the alternative location was production in the home country), comparing costs in Canada to costs in the United States, using the original United States information (price, quantity, costs). The *ex post* calculation, on the other hand, measures location savings after a TNC has closed its domestic location and opened operations in the host country; thus, the location savings are measured from the *new* location's perspective.

Which of the two approaches – *ex ante* or *ex post* – is better? There is no unambiguous answer to this question, but three observations can be made. First, from a TNC's point of view, the strategic issue is the determination of where to produce, so the *ex ante* figures are the critical perspective. The firm must compare its current location with other possible locations, so the initial location is the appropriate base case. Second, from the tax authority's perspective, when it seeks to determine the

arm's length transfer price, the available information is the current, that is, the *ex post*, situation. The output, price, costs and so on of the current producer are known. The hypothetical situation, for comparison, is with the original location, which may or may not still be in production. Third, from an economist's perspective, the issue is similar to the construction of price indexes. The Laspeyres index is based on the original price $((P1 - P0)/P0)$; the Paasche index on the new price $((P1 - P0)/P1)$. The preferable measure is a blend of the two: $((P1 - P0)/(P1 + P0)/2)$. Price index professionals, like transfer pricing professionals, understand the problem, but go ahead and use that which is most readily available (Diewert, Alterman and Eden, forthcoming).

Lastly, a key issue in location savings is not simply measuring the total size of the savings. From a transfer pricing perspective, the key issue is allocating the savings between the buyer and the seller, i.e. how much of the location savings belong to the buyer (who gets a price break) and how much to the seller (who gets to keep some of the location savings).

Economic theory tells us that the allocation of gains between two parties depends on their relative bargaining power, which depends on the goals, resources and constraints on each of the parties (Allen *et al.*, 2004: Eden, Lenway and Schuler, forthcoming). The stronger the resources or core competencies (e.g. tangible and intangible assets) held by one party, the greater is its bargaining power. The strength of one's resource base, in bargaining theory, is always measured from the other party's perspective. For example, suppose a distributor and a manufacturer are engaged in bargaining. The manufacturer owns product intangibles that produce a unique product that the manufacturer wants to sell in a local market; the distributor owns access to all the distribution channels in that market. Relative bargaining power depends on the valuation each party places on the other party's resources. The stronger the valuation that the manufacturer places on the distribution channels owned by the distributor, the greater is the distributor's bargaining power. The stronger the valuation the distributor places on the product

(and thus on the product intangibles) owned by the manufacturer, the greater is the manufacturer's bargaining power. Therefore, the intangibles held by each party are an important factor in allocating location savings between buyers and sellers.

In teleservices, the parent firm normally has developed and owns valuable intangibles (production, marketing and managerial assets) that are essential to its competitive advantage as a teleservices firm. These intangibles are what distinguishes one teleservices firm from other teleservices providers, and what leads third party firms such as MCI and UPS to outsource their customer relationship management activities to one particular teleservices firm rather than another. On the other hand, call centre affiliates typically have few or no intangible assets of their own nor hold any unique assets that are not available through other channels. For example, call centre affiliates normally do not own a unique distribution channel, control only the labour supply available for a particular activity, or own the only raw material (e.g., bauxite) that can be used in a particular refinery (e.g. alumina). This suggests that a larger share of the profit should go to the parent firm, reflecting its greater share in the activities, intangibles and risks. Moreover, economists tell us that the elasticity of demand and supply is also critical here. The elasticity of supply is determined by the number of alternative sellers (suppliers) and the degree of competition among the suppliers. If there is strong competition (large numbers of sellers), the price elasticity of supply is high and the supply (marginal cost) curve is quite flat. If there are few suppliers and/or competition is weak, then the supply curve is inelastic and quite steep.

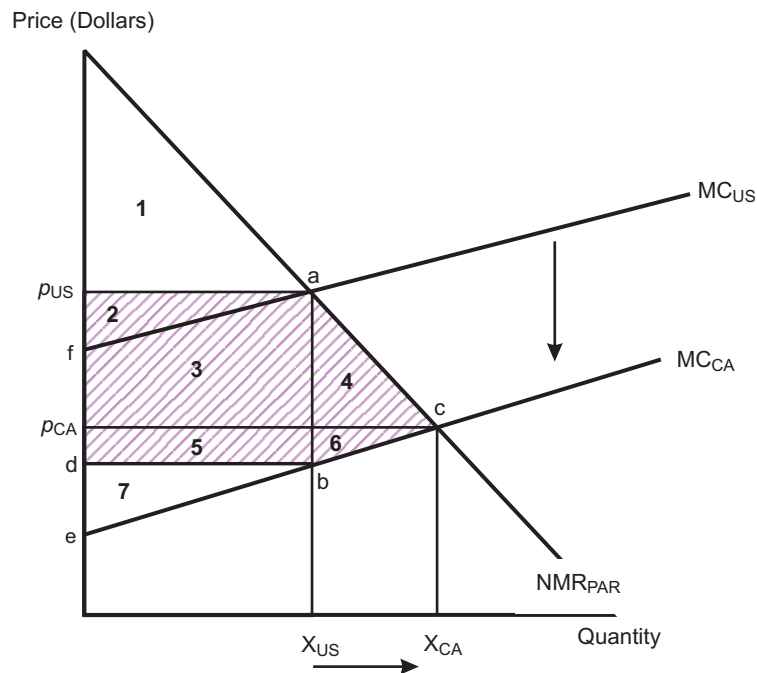
Figure 3, in which the value chain graph shows the activities (primary and support) performed by each of the parties, can be used to explore these arguments. Relative bargaining power depends on how critical each party views the other's activities. If one party were to replace its in-house partner with an arm's length partner, how easy is it to do that? Elasticity of demand and supply tells us which party is easier to replace. In the absence of the call centre foreign affiliate, the parent firm

could either provide the call centre stage itself (and may well do so) or shift its operations to another country (e.g. India, the Philippines) or, if it were willing, contract out the call centre stage to an arm's length supplier in the host country. The number of alternatives is high for the parent firm in terms of its choices for the call centre stage of the value chain. Moreover, the elasticity of factor supply to the call centre stage is also high since the work involves typically only a high school education. On the other hand, in the absence of the parent firm, the call centre would have to either scale up and perform all the activities that its parent firm currently provides (the purple shaded areas in figure 3) or contract with another teleservices TNC to provide these activities. Elasticity therefore implies that relative bargaining power remains with the parent firm.

Note that, as time passes, the supply and demand elasticities will both rise. In the short run, the number of available alternatives is limited, so price elasticity is lower. However, unless there are strong barriers to entry in this industry, high profits (rents) attract new firms and elasticity rises. The teleservices industry is clearly labour intensive and mobile; thus, firms can move sites from one location to another relatively easily. This mobility increases in the long run when all costs are variable costs.

Figures 6 and 7 explore the allocation of the location savings from an *ex ante* perspective from a TNC's viewpoint. Assume that the teleservices firm consists initially of a United States parent firm and a domestic affiliate. The parent firm is contemplating closing its domestic site and opening a new site in Canada to take advantage of location savings. The per-unit location savings is shown by the vertical downward shift in the marginal cost curve, i.e. $MC_{US} - MC_{CA}$ measures the per-unit location savings, between Canada and the United States, at the call centre stage of the value chain. The issue, therefore, is the total amount of the location savings and their allocation between the buyer (the United States parent) and the seller (the Canadian affiliate CANCO). The figures do not tell us the reason behind the location savings, just that they exist and can be measured.

Figure 6. Location savings for a teleservices TNC in the short run



Source: the author.

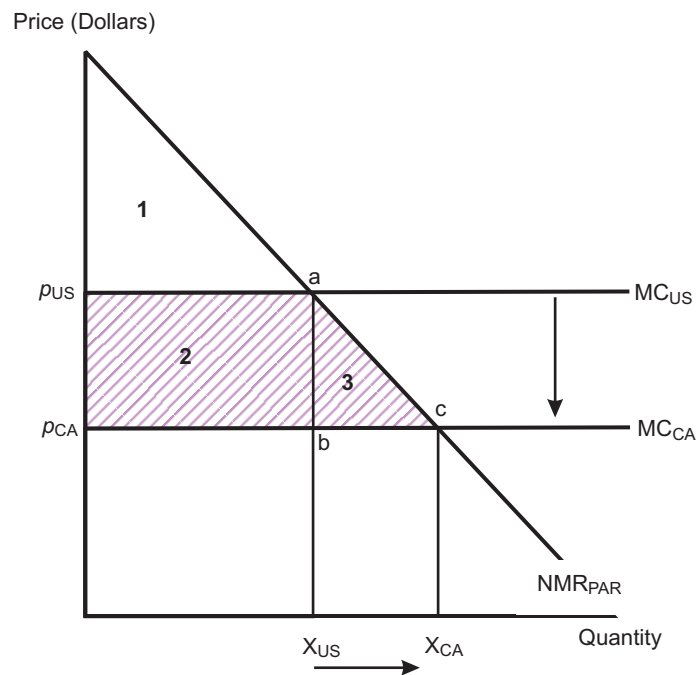
Note that all prices and costs in figure 6 are in a common currency, assumed to be the United States dollar. There are several possibilities, depending on the elasticities of demand and supply. Two cases are illustrated below, one short run (figure 6) and a second longer term (figure 7).

In figure 6, the marginal cost curve for the call centres is assumed to be quite flat, reflecting the high substitutability and dearth of intangibles at this stage of the value chain. With some simplifying assumptions, it is possible to do a quick analysis of how the location savings are distributed in figure 6. Point a represents the base case (the call centre is located at home). The TNC's total profit is represented by the area under the NMR_{PAR} curve and over the MC_{US} curve, that is, by area 1 plus area 2. The transfer price, p , splits the profits between the

buyer and seller, with the parent firm (the buyer) getting area 1 and the seller (the domestic affiliate) getting area 2.

Assume MC_{CA} is parallel to, and lies below, MC_{US} by the distance ab . This distance represents the per-unit location savings that the firm could earn if it closed the United States affiliate and shifted production to Canada. Suppose this occurs. The resulting lower costs encourage expansion of output, and the new equilibrium is at point c . Total profits of the TNC have now expanded to the area under NMR_{PAR} and over MC_{CA} , that is, to areas $1 + 2 + 3 + 4 + 5 + 6 + 7$. The net gain in the TNC's profit is areas $3 + 4 + 5 + 6 + 7$. Because I assumed the two MC curves were parallel to one another, by construction, areas $3 + 5 + 7$ must equal areas $2 + 3 + 5$, which means area 2 equals area 7. Thus, the overall gain in the TNC's profits due to location

Figure 7. Location savings for a teleservices TNC in the long run



Source: the author.

savings is areas 2 + 3 + 4 + 5 + 6, which equals rectangle $p_{us}abd$ plus triangle abc . The efficient, and profit-maximizing, transfer price p_{CA} is determined by the intersection of NMR_{PAR} with MC_{CA} at point c . Thus, the parent firm receives areas 3 + 4, while the Canadian affiliate receives areas 5 + 6. The flatter the marginal cost for the call centre, the greater is the share of profit going to the parent firm.

In the long run (five years say), looking ahead to the competition from India and the other countries included in table 2, one might expect the foreign affiliate's cost curve to be almost horizontal, implying all or almost all location savings should accrue to the United States parent firm. This situation is illustrated in figure 7. Assume, again, that the teleservices TNC consists of a United States parent firm and its domestic affiliate. The original equilibrium is at point a . Because MC_{US} is flat, all the profit (area 1) goes to the parent firm. If the parent firm closes the United States affiliate and shifts production to Canada, substantial location savings are made (area 2). The TNC expands production based on these savings, so the new equilibrium is at point c . Total profits are now areas 1 + 2 + 3; but because MC_{CA} is flat, all the location savings accrue to the United States parent firm. The foreign affiliate receives a normal rate of return for its services, but no more.

One last issue related to location savings is the question of whether they remain with the TNC (parent firm plus affiliates) or are moved downstream to third party clients. This issue also depends on the goals and resources of, and constraints on, the two parties, where the parties are now the teleservices firm and its third party clients. Since the client firms are typically Fortune 500 firms and there are large numbers of teleservices firms, this suggests that bargaining power is more likely to be on the side of the Fortune 500 client firms. In that case, the net marginal revenue curve of the parent firm, NMR_{PAR} , will be quite flat, reflecting the high degree of competition in the market for teleservices and the teleservices firm's relatively low bargaining power vis à vis its third party clients. In this situation, the location savings are likely to be passed to third party client firms.

Dossani and Kenny's (2004) example comparing Kansas City with Mumbai illustrates this situation. In their example, a 20% markup over costs at the United States site results in a price to third party clients of \$12.47 per hour; a 100% markup over costs at the Indian site yields a price of \$4.12 per hour. Implicit here is the assumption that most of the location savings were passed downstream to third party clients. If both sites were owned by one TNC and both offered identical services priced at \$12.47 per hour, the Indian site would have made \$10.39 ($\$12.47 - \2.08) as a gross markup instead of \$2.08. This suggests that about four-fifths ($2.08/10.39$) of the location savings were passed downstream to third party clients, with the remaining one-fifth allocated between the TNC parent firm and its Indian affiliate, depending on the transfer price.

In sum, because teleservices TNCs “went for cost”, there are usually location savings involved in offshored business services. Economic theory tells us that location savings are allocated between the parent firm and its foreign affiliate based on relative bargaining power. Relative bargaining power in this situation lies with the party that has the greatest resources and the least constraints on its activities. This is clearly the parent firm because it owns the production, marketing and management intangibles associated with this TNC, assumes most or all of the risks, and performs most of the functions. Relative bargaining power therefore favours allocating any residual profits to the parent firm. In addition, given the low tech nature of call centre activities and the ready availability of low skilled labour willing to perform these activities, the economics of the call centre stage also support the shift of location savings (to the extent they exist) to the parent firm. The high elasticity of supply for the call centre foreign affiliate implies that location savings go primarily to the TNC parent firm in the short run.

7. Policy recommendations and conclusions

All indicators suggest that the world economy is at the beginning of a major shift in business services, from in-house

onshore activities to outsourced offshored activities. Some argue that this is a “second wave”, following the “first wave” of movement of manufacturing activities offshore in the 1960s and 1970s (Dossani and Kenny, 2004; UNCTAD, 2004). Understanding the implications of this new trend is a fundamental issue for international business scholars and policy makers in the 21st century.

The teleservices industry is clearly one of the industries at the forefront of this movement. As such, it can provide useful lessons for thinking about other service industries. Teleservices TNCs are vertically and horizontally integrated. The transfer pricing literature tells us that the optimal transfer price for such a firm equates the net marginal revenue of the parent firm to the marginal costs of each of the call centres. The optimal transfer price determines how the profits between parent firm and affiliates are split. The parent firm’s profit is determined by the elasticity of the net marginal revenue curve while the foreign affiliate’s profit is determined by the elasticity of its marginal cost curve. The elasticity of the foreign affiliate’s marginal cost curve in turn is affected by factors such as costs, skill level and availability of labour. Since call centres are typically located in areas in which labour costs are low, and low-skill labour is in plentiful supply, the foreign affiliate’s marginal cost curve is highly elastic, translating into a smaller share of profits for the call centre relative to its parent firm.

If an external market price existed at the call centre stage (it appears not to), the Hirshleifer Rule tells us that this would be the profit-maximizing transfer price. Moreover, transfer-pricing regulations (OECD, 1995; IRS, 2003) suggest that the best method to be used in this situation is a CUP. However, since an external market price does not exist at the call centre stage of the value chain, CUP is not an appropriate method in this situation. Moreover, the resale price method is inappropriate because of the intangibles held by the parent firm and because it allocates all residual profits to the call centre stage. CPM and TNMM are difficult to apply because of the lack of data on profit margins at the call centre stage.

In this article, I have argued that the cost plus method is the best method for pricing call centre activities. Since the call centre is basically a contract services provider, the cost plus method – which treats the manufacturer (in this case, the service provider) as a contractor producer and allocates the residual profits to the downstream firm – is the appropriate method. Another possible method would be the residual profit split method. It would give basically the same result but would involve substantially more work (and guesswork) because the individual intangibles would need to be valued. Thus, the cost plus method also dominates the residual profit split. Moreover, I argue that location savings typically belong to the TNC parent firm, not to the call centre site, given the typical functions, assets, risks and economic circumstances of call centres. I therefore argue that the transfer-pricing maxim for teleservices TNCs should be: “Went for cost, priced at cost” (plus a small mark-up).

These conclusions are likely to be controversial for the following reasons. First, the argument that the best method rule is the cost plus method allocates the lion’s share of profit back to the TNC parent firm, increasing the taxable income base in the home country. This should be welcome news to the home country Governments; on the other hand, host country Governments – those where the call centres are located – are also hungry for tax revenue and a cost plus methodology clearly leaves them even hungrier. Recent moves to develop transfer pricing rules for offshored business services by both the United States and Indian tax authorities are emblematic of the importance and controversy associated with this topic. Unfortunately, simply stating that transfer-pricing rules must follow the OECD’s arm’s length standard is not sufficient to

¹⁴ The Indian tax authority’s September 2004 circular states, in paragraph 6: “In determining the profits attributable to an IT enabled BPO unit constituting a Permanent Establishment, it will be necessary to determine the price of the services rendered by the Permanent Establishment to the Head office or by the Head office to the Permanent Establishment on the basis of the ‘arm’s length principle’”. While this is a necessary condition, it is not sufficient to avoid international tax disputes. See Fazelbhoy (2005, p. 36).

avoid controversy and double taxation.¹⁴ From a TNC's perspective, the worst of both worlds is for both Governments to use gross margin methods: cost plus by the home country Government (shifting the bulk of profits to the parent firm) and the resale price method by the host country Government (shifting profits to the foreign affiliate). The residual profit caused by the continuum price problem is therefore taxed twice, even though both Governments are following the arm's length standard. As more activities are shifted offshore, the reality of double taxation becomes even more likely.¹⁵ To the extent that tax authorities better understand the economic principles behind taxing business services, such conflicts should be less likely.

Moreover, there are now many countries competing to attract call centres. Given the labour-intensive nature of production and the higher mobility of capital in this industry, any attempt by one host country Government to tax a call centre too highly, or double taxation through conflicting transfer pricing methods not resolved at competent authority, could easily cause capital flight to another location. While tax havens are not currently major host locations for call centre activities, they do offer potential roosting havens for the mobile geese of the 21st century. Again, a better understanding of the economics of transfer pricing should help reduce the incentives for capital flight.

One caveat is in order. I have assumed that call centres engage in low-skilled teleservices activities with few intangibles. This accurately characterizes most of today's offshored business services. However, the maxim "Went for cost, stayed for quality" (Dossani and Kenney, 2003) suggests that the level of skills in these centres is increasing. Moreover, there are a variety of business services now being offshored. For business services that are clearly sophisticated (level 3 services in figure 3), the residual profit split method may be a better method than the

¹⁵ Ernst & Young (2003) found that 40% of all transfer-pricing adjustments resulted in double taxation. This percentage will likely increase as business services grow as a percentage of international intrafirm transactions.

cost plus method for allocating profits between a TNC parent firm and its offshore affiliate. Therefore, over time, as the quality and complexity of offshored business services increases, I expect the applicability of the cost plus method to decline. Unfortunately, shifting to other methods such as residual profit splits and TNMM is likely to exacerbate transfer-pricing disputes in this industry. The need for a multi-Government approach (e.g. through multi-country Advanced Pricing Agreements) is therefore likely to become more important over time.

This article contributes to the international business literature in several ways. First, it contributes to the growing literature on offshoring and outsourcing of business services by providing a detailed economic analysis of one of the most common offshored services, teleservices (more generally, customer relationship management). Second, it analyzes transfer-pricing regulation of business services, focusing on the United States proposed transfer-pricing regulations. Its economic analysis of the international business of teleservices adds to a transfer-pricing literature dominated by lawyers and accounting professionals. Third, it has extended the literature on location savings, which was developed for offshored, labour-intensive manufacturing in the 1970s and 1980s, to apply to offshored business services in the 21st century. Fourth, it brings the literatures on offshored business services and transfer pricing together, two research areas that have had little connection between them to date. As globalization intensifies, understanding both the international business and the transfer pricing aspects of offshored services becomes increasingly important for both TNCs and Governments. Lastly, the article has implications for the OECD, suggesting it is time to develop guidelines that are more sophisticated for the transfer pricing of offshored services, along the lines of IRS (2003). The development of a model template for a Multi-Government Advanced Pricing Agreement (MAPA) for business services would also help to reduce intergovernmental tax disputes.

In conclusion, international tax authorities and TNCs need to pay close attention to the transfer pricing of offshored business services because there are more complications and uncertainties

involved in this new area of international commerce than in traditional taxation of goods and raw materials. In this article, I have attempted to outline the problem areas, evaluate the alternatives and propose solutions. Even though the catchphrase “Went for cost, stayed for quality”, affirms the importance of both cost and quality as location drivers in the teleservices industry, “Went for cost, priced at cost”, remains the appropriate transfer-pricing maxim for both TNCs and Governments, at least for the foreseeable future. ■

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Global technology: innovation strategies of foreign affiliates in Italy

Giovanni Balcet and Rinaldo Evangelista*

The relevance, nature and economic effects of innovation activities of transnational corporations are highly debated topics in the current literature on the “globalization of technology”. A controversial theme concerns the innovation strategies of foreign affiliates and the role they play in host countries. This article sheds new light on this topic by assessing the technological contribution of foreign affiliates in Italy; comparing the innovation performance and strategies of foreign affiliates and domestic firms; and qualifying the main patterns of innovative activities of transnational corporations. The empirical evidence presented shows that foreign affiliates and domestic firms differ from each other more in terms of type of innovation strategies pursued than in terms of innovation performance. However, innovation strategies of foreign affiliates reflect a high degree of heterogeneity, being affected by the technological characteristics of an industry, the specific technological assets of firms as well as by some peculiar features of the Italian innovation and production systems,

* Giovanni Balcet is professor of International Economics at University of Torino, Italy. Rinaldo Evangelista is a researcher at the National Research Council of Italy (CNR-IRPPS, Rome) and a Professor on contract of Political Economy at Univerità di Camerino and CNR-IRPPS, Roma. Contact: giovanni.balcet@unito.it or r.evangelista@irpps.cnr.it. The firm-level data-set used for the empirical analysis presented in this article was generated through the merging of the ELIOS database developed by the University of Urbino and the CIS2 data provided by Istat. The authors are grateful to both Institutions and in particular to Antonello Zanfei and Davide Castellani of the University of Urbino and Giulio Perani of ISTAT for the access given to the micro-data. The authors are also grateful to three anonymous referees for their useful comments and suggestions. As usual the authors are solely responsible for the results presented and the views expressed in the article.

namely its specialization in traditional goods and mechanical engineering combined with its weakness in science-based industries. Three distinct innovation patterns of foreign affiliates were identified and labelled respectively as low-tech, adaptive and asset seeking. These patterns differ on the basis of the overall commitment of foreign affiliates to innovation, the sources and objectives of the technological activities undertaken and the nature, strength and geographical horizon of technological links established with the external environment. Among the three, the “adaptive” pattern is by far the dominant one, while foreign affiliates following an “asset seeking” strategy are rare, and they are surprisingly lacking in high-tech industries. The empirical findings reflect the structural features of Italian industry and innovation system and highlight some more general stylized features of innovation strategies of foreign affiliates.

Key words: technology, innovation, globalization, transnational corporations

1. Theoretical issues: the internationalization of technology by TNCs

The relevance, characteristics and economic effects of the internationalization of the innovation strategies of transnational corporations (TNCs), or technological globalization, are highly debated issues. There are three main dimensions of global technology (Archibugi and Michie, 1997):

- the exploitation and transfer of technological innovation in international markets;
- the international location of research and development (R&D) and innovative activities by TNCs; and
- international technological co-operation and networking.

Traditionally, the economic literature on TNCs considered the production of new technology to be heavily concentrated in their headquarters in the home countries, and then diffused internationally via foreign direct investment (FDI). The

international transfer of technology was at the core of the mechanism described, since the 1960s, by the well-known product-life-cycle model (Vernon, 1966). In this model, dynamic inter-relations between innovators and followers explain both the direction and evolution over time of international trade flows, as well as the crucial decision of innovative exporting firms to become transnational, via FDI.

The empirical evidence on trade patterns, FDI and patent distribution shows a positive correlation in most advanced countries between innovative intensity on the one hand, and export performance and international production on the other hand, while the pace of the product life cycle has been shortening over time in recent decades (Cantwell, 1997).

During the 1990s, the internationalization of the production of new technologies within TNCs, including R&D projects, process and product innovation, design and patenting, has become more and more relevant (Patel, 1997), with the exception of Japan. Strong sectoral specificity, as well as path-dependency, have been observed in the international fragmentation of innovative activities (Narula, 2003).

A multiplicity of locations of innovation centres within TNCs results from these processes (Dunning, 1993; Cantwell, 1994). Not only has incremental R&D been decentralized in order to adapt products to local needs and requirements, but some TNCs have also located segments of basic research abroad, as discussed in the next section.

Foreign ownership affects innovation processes because foreign affiliates may be more (or less) innovative than domestic enterprises, because of the specific advantages of transnationality (positive effects of operating in various countries), and because TNCs have by definition the advantage of belonging to a group (Jetto-Gillies, 2002).

We must note, however, that the international spread of technological capabilities may not only be the result of explicit innovation strategies developed by TNCs, but also the indirect

outcome of international acquisitions of innovative firms, aimed at different goals, such as market penetration.

The international spread and decentralization of innovative activities is driven by the following factors:

- the need to adapt products to local conditions, local regulations and constraints;
- good scientific infrastructure and human capital in the host country;
- the size and growth rates of foreign markets;
- high R&D intensity of the industry;
- the strategies of international location of R&D and innovation activities by direct competitors;
- the capacity of TNCs to manage efficiently complex research systems and innovation networks;
- acquisitions of firms abroad with complementary or similar technological capabilities; and
- the high cost of research and the lack of scientific infrastructure in the home country.

The spread of inter-firm cooperative networks characterizes what has been called “alliance capitalism”, where oligopolistic competition coexists with inter-firm cooperation (Dunning, 1997; Contractor and Lorange, 2002). The creation of international inter-firm R&D partnerships and research-oriented networks, developed since the 1960s (Hagedoorn, 2002), has been interpreted as a consequence of the shortening of the product life cycle (Cantwell, 1997). This trend was characterized by a new orientation of TNCs towards global asset-seeking strategies, which also implied a more active technological role of their foreign affiliates in host countries. The setting-up of linkages and relationships between foreign affiliates and local science and technological institutions has progressively become a characterising feature of this new strategy (UNCTAD, 2001).

A concentration of joint ventures and co-operation agreements has also been observed in new industries, such as information and communications technologies (ICTs) and

biotechnology. They involve both national firms and TNCs, as well as government agencies and academic centres. Partner firms may be vertically connected, or they may be operating in the same industry.

Technology-oriented joint ventures, international networks of alliances and co-operation agreements, while pushing ahead the international sharing of technological knowledge and practices, interact with the internationalization of innovative activities within TNCs, such as intra-muros R&D. A “learning-by-cooperating” effect has been observed in the case of Italian inter-firm cooperative agreements abroad (Balcet, 1988).

In several high-tech industries, such as telecommunications and software, network externalities are a primary source of competitiveness, and global technological standards shape the markets. Rival companies tend to cooperate in research, sharing their knowledge in strategic R&D intensive areas, while competing in final markets.

Governments and local administrations may deeply influence inter-firm alliances aiming to impose global standards, as a part of their strategic industrial policies (Narula, 1999; Hagedoorn, Link and Vonortas, 2000).

The innovation strategies and performance of foreign affiliates are therefore the result of various factors, the most important being the specific technological assets of TNCs that invest in a host country, the industry in which they operate and the technological attractiveness – i.e. localized context-specific factors – of the country/region hosting foreign affiliates (Dunning, 1997).

Technological knowledge and innovative capabilities may be embedded in a firm’s organization, or localized in a given territory (Antonelli, 1995, 1999). How these two dimensions interact with each other is a major analytical issue that needs to be addressed. In fact, TNCs search for scientific and technological resources that are country-specific and localized, actively interacting with them, and internalizing new

technologies within their organizations (Narula, 2003). Path-dependency may result at the firm level, because innovative capabilities are embedded in its organization, human resources and routines. At the same time, they may be localized in a territory or district, where technological externalities and agglomeration phenomena are more likely to arise. The relationship between local and global dimensions of technology is therefore a crucial issue (Cantwell and Iammarino, 2003).

This article seeks to shed light on these issues, investigating the intensity and the main features of the innovative activities carried out by foreign affiliates in Italy. Its basic questions are:

- What are the technological activities, innovation strategies and performance of foreign affiliates in Italy, compared to those of domestic firms?
- What are the main patterns of technological internationalisation of TNCs?
- How to assess the contribution of foreign affiliates to the creation of endogenous technological capabilities?

In answering these questions, we mean to contribute to the debate on the effects of technological globalization and, in particular, on the issue of the impact of TNCs on host countries. The list of questions above serves to exemplify the complexity and multidimensionality of the matter, which needs to be explored with robust data-sets and sound empirical evidence.

In order to investigate the qualitative and strategic aspects of these innovation strategies, it is crucial to identify some basic patterns of the innovative activities of TNCs, characterizing their behaviour and strategies. These ex-ante patterns are presented in the next section; they are the base for shedding light on the empirical evidence presented, based on the Italian case. Section 3 highlights some essential features of the pattern of “transnationalization” of Italian industry, relevant for analyzing the innovation strategies of foreign affiliates. Section 4 contains the empirical part of the article, presenting a description of the database. Section 5 provides a systematic comparison between

the innovative activities and performance of domestic firms and foreign affiliates, while the main typologies of innovative patterns of foreign affiliates are identified in Section 6. The concluding section brings together the main results presented in this article and draws some policy implications.

2. Patterns of innovative activities by foreign affiliates: low-technology, adaptive and asset-seeking strategies

A vast amount of literature suggests that a variety of patterns of technological globalization are likely to coexist, depending on the specific technological characteristics of industries, as well as on the basic technological and economic features of host countries and regions. Based on Christian Le Bas and Christophe Sierra (2002), we can identify *ex ante* three different types of strategies and innovative behaviours of foreign affiliates:

Low technology foreign affiliates

Foreign affiliates characterized by weak internal knowledge assets and poor innovation performances comprise a first category.

This pattern may fit well with the first stage of the already mentioned traditional product-life-cycle scheme, and with Raymond Vernon's (1966) hypothesis of unidirectional centre-periphery technology flows. Foreign affiliates produce innovative goods designed and developed abroad, mainly in the home country of TNCs. Their main missions are the production and distribution of commodities. They can be either export-oriented or local-market oriented. In the first case, their export performance is not explained by competitive advantages based on innovation, but rather by other types of competitive factors such as economies of scale, skills, brands, marketing capabilities and organization. In the second case, they serve the domestic market without any significant adaptation of the product to local needs, regulations and market conditions.

This pattern is associated with strategies of internationalization of production with little commitment to innovation. The propensity to introduce innovation is likely to be very low, with process innovation playing a dominant role. R&D activities (both internal and external) are expected to be absent or very limited, with most of the innovative efforts being focussed on the acquisition of machinery and new equipment. We can expect that both the import of innovations developed elsewhere (especially by the parent company) and investment in new machinery represent a large share of total innovation costs. Technological interactions and knowledge flows with the external environment are expected to be very low or absent.

Domestic market oriented strategies and adaptive innovative activities

In this second pattern, innovative activities abroad are mainly meant to adapt products or processes to the specific features of local demand and regulations. R&D is mainly contextual to local production, and is expected to be incremental and limited to product development, not including the generation of general-purpose technologies and basic research. It may correspond to a second evolutionary stage of the product life cycle, building on the previous simple transfer of technology from the centre to the periphery.

The main motivation of TNCs in this case is access to domestic markets, through acquisitions or greenfield FDI, and the exploitation of innovative advantages created abroad and transferred from the home country or from other affiliates of the group. Therefore, this pattern represents the first step of a process of the internationalization of innovation.

The existing empirical literature also suggests that the customization and adaptation of existing products and technologies is the most frequent motivation of TNCs – and the main driver – of the internationalization of innovation.

This pattern has been defined in terms of “asset-exploiting R&D” (Dunning and Narula, 1995), “home-base exploiting”

innovative activities abroad (Kuemmerle, 1999), or “exploitation, refinement and extension” of existing technologies and competencies (March, 1991).

We can expect that foreign affiliates following this strategic orientation are characterized by relevant intra-group technology inflows, and that the innovation intensity itself may vary; it can be relevant in some cases, but is expected to be, on average, lower than in the “global” pattern defined below.

The adaptive pattern is characterized by innovation strategies that are not meant to be “radical”. The innovation output is likely to be made up of a mixture of product and process innovations, with some of these developed by the head of the enterprise group and transferred to foreign affiliates. Accordingly, compared to the asset-seeking profile, R&D activities play a less crucial role in this innovation pattern. In this case, foreign affiliates are more likely to rely upon external R&D services (acquired from headquarters) and incremental knowledge sources (such as design, trial production).

With the exception of intra-group linkages, knowledge flows with the external environment (both local and global) are expected to be limited. Both production and innovation activities of foreign affiliates aim at adapting to local markets products and technologies developed within a group. As a consequence, the export propensity of foreign affiliates is expected to be rather low.

Global technology: asset-seeking innovative activities

In this pattern, innovative activities are carried out within international research networks, in order to develop distinctive knowledge assets and technological capabilities. Innovative activities are integrated within macro-regional or global transnational networks in which foreign affiliates share a good deal of general purpose knowledge and technology.

In several high-tech industries, an increasing proportion of FDI has been motivated by the acquisition of new technologies

and the setting-up of networks for the international sourcing of scientific and technological resources. The role of external actors and institutions for developing new knowledge is important in this strategy, giving rise to technological alliances (section 1).

The proximity of technological districts, universities and research institutions, as well as the availability of highly qualified human resources, strongly supports this strategy, developed through the acquisition of existing R&D units or through greenfield R&D investments. Agglomeration phenomena and technological clusters generate locational advantages for these foreign affiliates. For example, Paul Almeida (1996) has provided extensive evidence on the case of FDI in the semiconductor industry in Silicon Valley, where technology-seeking foreign affiliates have been rather effective for enhancing the catching-up of transnational newcomers and followers (Kim, 1997).

As a consequence, foreign affiliates pursuing an asset-seeking strategy are also capable of exporting technologies, patents and new components and products, in particular within their corporate group. Moreover, we can expect that, in this case, an important share of the production of foreign affiliates will be export oriented.

This pattern was envisaged in one of his late works by Raymond Vernon (1979) who defined highly developed TNCs as “global scanners” and suggested an active role of foreign affiliates in the creation of new products. In the most recent literature, “strategic asset-seeking activities” (Dunning and Narula, 1995) have also been defined in terms of “knowledge-based FDI” (Frost, 2001), “home-based augmenting activities” (Kuemmerle, 1999) or “exploration and experimentation” strategies (March, 1991).

Firms following an asset-seeking pattern are expected to show a heavy commitment to innovation activities, with a high propensity to introduce product innovation developed internally and large resources devoted to (internal) R&D. The radical

nature of technological activities carried out by foreign affiliates should lead to some patent activity, significant intra-group technology outflows and the establishment of systematic relationships with universities and R&D centres. The geographical horizon of these knowledge interactions, and in particular cooperation, should not be confined to intra-group linkages but should go beyond the region where foreign affiliates operate. High export propensity is also likely to be associated with such a pattern.

The characterizing features of the three innovation patterns described above are synthesized in table 1 and will be used as *ex-ante* typologies to be explored and empirically tested in section 6. It should also be stressed that these patterns are stylized typologies. In fact, mixed forms, intermediate strategies and, more interesting, evolutions from pattern B to pattern C can be frequently observed. Technological competencies in R&D units abroad in a first stage are often created to cope with local adaptation needs; but in a second stage the same units may develop autonomous technological capabilities and also transfer technologies within the transnational network they belong to. This trend has been observed in the case of German TNCs (Wortmann, 1990), as well as in the automotive industry (Balcet and Enrietti, 2002).

3. The sectoral patterns of employment in foreign affiliates in Italy: the role of science-based industries

As mentioned, the innovative behaviour of foreign affiliates is explored empirically in the following sections, looking at the case of Italy. It is therefore important to start to address our empirical agenda by providing some preliminary evidence on the pattern of the transnationalization of Italian industry, especially with reference to its sectoral characterization. Even a simple sectoral breakdown of the data on inward FDI over the past 15 years can provide indirect indications of the technological attractiveness of the Italian innovation system.

Table 1. Innovation patterns of foreign affiliates: hypotheses and expected results

Variable	Innovation patterns of foreign affiliates		
	Low tech	Adaptive	Asset seeking
Type of innovation	Process	Product (incremental)	Product (radical)
Internal capability to generate innovation	Low	Medium	High
Innovation intensity (resources devoted to innovation & R&D)	Low	Medium	High
Dominant type of innovation activity	Adoption of new equipment and machinery	R&D (external) & design contextual to local production	R&D (internal) & patenting
Innovation strategy (objectives of innovation)	Lowering cost	Incremental (Improve quality, fulfil regulations and standards)	Radical (Substitute products, enter new markets)
Cooperation			
- with universities, R&D centres, clients, suppliers	Very low	Low	High
- within the group	Low	Medium	High
- within the group only	High	Medium	Absent
- world-wide cooperation	Absent	Low	High
Other external linkages (with universities, R&D centres, suppliers)	Very low	Low	High
Export propensity	-	Low	High

Source: the authors.

Table 2 shows that most employment in foreign affiliates is concentrated, as expected, in scale-intensive industries. It is well known that these industries, as well as the science-based industries, are dominated by large corporations operating on an international scale. Their share has grown from 44.3% in 1985 to 51.8% in 2003.

It is interesting to note, for our purposes, that, in 1985, science-based industries represented 31.5% of foreign affiliates' total employment, but this share has been continuously decreasing since then, reaching 26.0% in 1995 and 22.7% in 2003. Such a trend may be interpreted as the result of a decreasing attractiveness of Italy in high-tech industries, which could be due to decreasing investment, both private and public, in innovation, R&D, technological infrastructures and higher education (Fagerberg *et al.*, 1999).

An international comparative analysis of the Italian pattern of transnationalization can be done by looking at the role played by foreign affiliates (in terms of output shares) in the most innovative industries in different countries (OECD, 2001). In a group of highly technologically-attractive countries such as the United States, the United Kingdom, France, Germany, Sweden, Finland, and the Czech Republic, foreign affiliates are concentrated in the most innovative industries; a share between 50% and 70% of their production belongs to "high technology"

Table 2. Employment in foreign manufacturing affiliates in Italy and in foreign affiliates of Italian firms, by macro-sectors (at year end)

Type of industry	1985	Per cent	1995	Per cent	2003	Per cent
Scale-intensive	206 172	44.3	255 490	48.8	318 573	51.8
Science & technology-based	146 644	31.5	136 030	26	139 693	22.7
Specialized suppliers	86 156	18.5	101 458	19.4	117 665	19.2
Traditional	30 866	6.6	30 057	5.7	38 496	6.3
Total industry	465 143	100	523 035	100	614 427	100

Source: Mariotti and Mutinelli, 2004.

or to “medium-high-technology” groups of industries.¹ The Italian case seems more similar to that of the Netherlands, Poland and Norway, where foreign affiliates are concentrated in less technology-intensive industries. However, the share of employment of foreign affiliates in science-based industries is still higher than the share of domestic Italian firms in the same industries; this is a result of the well known weaknesses of the Italian innovation system and in particular of its R&D-intensive industries (Malerba, 1993; OECD, 2004; Ferrari et al., 2004). These weaknesses are confirmed also by the limited presence of Italian TNCs abroad, especially in the science-based industries. These industries account for less than 10% of the total employment of Italian foreign affiliates abroad. Therefore, the pattern of international production is converging with the pattern of international trade, especially in the case of traditional and specialized mechanical engineering industries, which account for a high share of Italian exports² (Balcer, 1997).

The overall picture provided by table 2 does not allow us to assess what is the dominant driver of innovation activities by TNCs in Italy and, in particular, what is the dominant one between strategies aimed at:

- manufacturing in the country on the basis of imported technologies, in order to penetrate the large domestic market and/or to export to other European Union countries; and
- decentralizing a substantial part of their technological activities to foreign affiliates located in Italy in the context of an asset-seeking strategy. In this case, foreign affiliates are expected to create linkages and to contribute to the development of the country’s national innovation system.

¹ Japan and Ireland also show very high values, but their cases are very peculiar, for opposite reasons: the very low penetration of TNCs in the former, and the very high penetration in the latter.

² In the specialized suppliers industries, Italian companies (usually small in size) show a limited but growing propensity to invest abroad, although they are highly export oriented. The share of foreign production in traditional industries grew significantly during the 1990s, thanks to a process of relocation of production capacity to low wage areas such as Eastern Europe.

The limited empirical evidence available on this topic shows that both types of strategies can be observed. In some cases, R&D-intensive Italian firms have been acquired by their foreign competitors (e.g. the pharmaceutical industry), which have integrated Italian R&D divisions into their international networks, coordinated by regional or global headquarters.

An exploratory study, based on the information provided by the first Community Innovation Survey (CIS) for the year 1992, estimated that foreign affiliates accounted for 23.1% of total industrial R&D expenditure in Italy (Balcet and Cornaglia, 2001).

Most of the crucial questions raised in section 1 concerning the relevance and impact of technological spillovers from foreign affiliates and the innovation strategies and performance of foreign affiliates are still open in the case of Italy. Further investigation is therefore needed.

4. Data and methodology

The empirical analysis presented in this article is based on the use of data provided by the Italian innovation survey (part of the second CIS), carried out in 1997 and covering to the period 1994 through 1996. The CIS provides a wide range of information on the specific innovation strategies and performance of firms and also on their ownership structure. Firms are in fact asked whether they are part of an enterprise group and, if so, to indicate the nationality of the head office. This piece of information is however based on a rather loose definition of “ownership” and may be unreliable regarding who is the ultimate beneficial owner of firms. More reliable information on the true nationality of firms, considering the whole chain of control, has therefore been drawn from the ELIOS database (European Linkages, International Operations and Ownership Structure) developed by the University of Urbino. The latter is a Pan-European data-set based on Bureau Van Dijck “Amadeus” and Dun and Bradstreet “Who Owns Whom” databases (Castellani and Zanfei, 2002, 2003a, 2003b).

The firm-level data-set used for the empirical analysis presented in the following two sections is the result of the merging (at the firm level) of the Italian CIS2 data-set and the ELIOS database. The outcome is a data-set (hereafter called CIS2-ELIOS) of 1,115 observations, containing all CIS2 variables and the “Who Owns Whom” information on the transnationality of firms.³

In the empirical analysis, we focus on selected variables contained in the CIS2-ELIOS database, namely those providing information on the following: the ownership/transnationality of the firm (domestic/foreign and nationality of the head office) and its export propensity; the presence of innovation activities and the type of innovation introduced (product/process); the type of innovation inputs used (R&D, investment and other inputs) and the amount of resources devoted to such activities (both per employee and as a share of total innovation costs); the technological linkages and interactions with the external environment (degree of importance) and the presence, scope and geographical horizon of cooperation (see table 4 for a detailed description of the indicators used in the empirical analysis).

The structure and sectoral coverage of both the Italian CIS2 sample (representative of all Italian manufacturing firms with more than 19 employees) and the CIS2-ELIOS data-set are shown in table 3. The comparison between the two data-sets reveals that the CIS2-ELIOS database is somewhat biased towards large firms. While in the CIS2 data-set the first firm

³ As mentioned, the CIS-ELIOS data-set refers to the 1994-1996 period. This is a clear limitation. The merging at the micro level of CIS 2 data with other information sources (i.e. the ELIOS database) required solving a series of complex methodological problems and following time consuming administrative procedures. This means that updating our empirical exercise would have required a substantial delay in the circulation and publication of the results.

However, it is reasonable to argue that the innovative patterns of foreign affiliates identified in the following sections are rather structural, as it reflects innovative behaviour and performance, as well as the presence of contextual factors, which are not expected to change substantially in a short time.

size class (20-99 employees) accounts for 88% of total manufacturing firms and 41% of total employees, in the case of the CIS2-ELIOS sample, the same size class accounts for a much lower share of firms and employees (22% and 2%, respectively). The sectoral coverage of CIS2-ELIOS is much more balanced and closely mirrors that of CIS2. This guarantees a reasonably good sectoral representativeness of our data-set. More than one third of firms in the CIS2-ELIOS sample are foreign affiliates of TNCs whose head office is located outside Italy. The remaining observations are either Italian independent firms or firms owned by an Italian head office.

The industrial break-down presented in table 3 corresponds roughly to a two digit NACE Rev1 classification. In some cases, industries have been pulled together in order to reach a minimum number (three at least) of foreign affiliates in each industrial group. The industrial and firm size breakdowns presented in table 3 are used to control for the presence of fixed factors in the econometric estimates presented in the following sections.

5. A comparison between foreign affiliates and domestic firms

In this section we start exploiting the information contained in the CIS2-ELIOS database by assessing the technological contribution of foreign affiliates in a host country such as Italy. This exercise is carried out by comparing the innovation performance and strategies of foreign affiliates (abbreviated as FAs) and those characterizing domestic firms (DOM). The questions we try to answer are the following:

- Are foreign affiliates more innovative than domestic firms?
- Are the innovation strategies of foreign affiliates different from the ones characterizing domestic firms?
- Do foreign affiliates rely on different types of knowledge sources?
- What kind of technological links do foreign affiliates establish with the local environment?
- Are differences in the innovation performance of foreign affiliates and domestic firms industry specific?

Table 3. CIS2-ELIOS sample

Item	CIS2 universe						CIS2-ELIOS sample					
	Total sample			Foreign affiliates								
	No. of firms	Per cent	No. of employees	Per cent	No. of firms	Per cent	No. of employees	Per cent	No. of firms	Per cent	No. of employees	
Sectors												
Oil, gas, metal extraction	733	2	202 927	7	37	3	125 076	15	13	4	3 093	1
Food, beverage and tobacco	2 744	7	234 765	8	65	6	51 212	6	21	6	28 943	13
Textile, footwear, wood, furniture	10 422	26	539 271	17	138	12	57 998	7	15	5	5 474	3
Paper and printing	2 054	5	147 654	5	76	7	34 576	4	17	5	7 017	3
Chemical products	972	2	128 750	4	78	7	48 438	6	38	11	22 940	11
Pharmaceutical products	267	1	62 152	2	39	3	28 000	3	21	6	16 673	8
Rubber and plastic	2 127	5	135 311	4	64	6	29 140	4	21	6	14 794	7
Metals	3 160	8	279 570	9	124	11	81 499	10	24	7	14 994	7
Metal products	5 641	14	259 461	8	74	7	16 582	2	21	6	4 800	2
Mech. machinery	4 851	12	400 167	13	179	16	100 232	12	54	16	39 327	18
Office machinery, electr. equip. products	3 109	8	308 878	10	138	12	82 846	10	51	15	43 099	20
Automobile components	486	1	67 308	2	29	3	20 783	3	23	7	9 448	4
Other transport	638	2	209 670	7	32	3	120 945	15	3	1	1 181	1
Other industries	2 700	7	134 647	4	42	4	12 887	2	9	3	4 437	2
Firm size classes (number of employees)												
20-99	34 941	88	1279 903	41	243	22	13 341	2	62	19	3 491	2
100-499	4 415	11	833 831	27	579	52	157 679	19	158	48	43 813	20
500 and over	548	1	996 798	32	293	26	639 194	79	111	34	168 916	78
Total	39 904	100	3 110 531	100	1 115	100	810 214	100	331	100	216 220	100

Source: the authors.

Table 4 provides a comprehensive picture of the results of the comparisons between foreign affiliates and domestic firms in the CIS2-ELIOS sample, using a wide range of indicators contained in the data-set.⁴ The first two columns show for each indicator the average values for domestic firms and foreign affiliates, respectively; when foreign affiliates and domestic firms are compared at such an aggregate level, the following picture emerges: foreign affiliates show a higher propensity to innovate (INNO), rely more on R&D activities (RDY, RDEXTY) and tend to cooperate less with other firms and institutions, although they show frequent cooperation agreements with other firms within the corporate group that they belong to. In particular, the share of innovating firms is 5% higher among foreign affiliates than among domestic firms. Furthermore, compared to domestic firms, foreign affiliates devote a higher share of their innovation expenditures to R&D (both internal (+22%) and external (+46%)) and cooperate less with universities (-16%), R&D centres (-35%) and suppliers (-34%).

These results are likely to be affected by compositional effects, especially the concentration of foreign affiliates in science-based and scale-intensive industries and by the average size of foreign affiliates (which is much larger than that of domestic firms). To get rid of these effects, we can look at the last column of table 4, which shows the *b* coefficients estimated by running multinomial logit and ordinary least squares regressions with the inclusion of control factors (column 3). Each indicator (used as a dependent variable) has been regressed against the indicator “FA” (binary variable indicating foreign ownership of a firm) and a series of industry and firm size dummies. A positive sign of the *b* coefficient indicates the presence of a positive difference in the average values between foreign affiliates and the group of domestic firms after having controlled for the presence of fixed effects.

⁴ For most indicators (those signed with a star in table 5) the comparison between foreign affiliates and domestic firms is made using data for a sub-sample of 584 innovating firms, excluding firms with missing values in the case of the most relevant indicators. The representativeness of this sub-sample – both across industries and firm size classes – remains nonetheless reasonably good.

Table 4. Innovation performances of foreign affiliates (FA) vis à vis domestic firms (DOM)

Type of indicator	Description	DOM		FA		FA-DOM	
		average values	average values	Logit & OLS estimates (with control factors) B coeff.	(associated to FA)	Sig	
<i>Innovativeness</i>	Per cent of innovating firms	70.9	77.4	0.04	0.817		
<i>Type of innovation</i>	product innovation (%)	86.5	90.2	0.19	0.490		
	- product innov. developed internally (%)	68.5	69.1	-0.13	0.482		
	- product innov. developed in coop. (%)	24.9	28.9	0.07	0.728		
	- product innov. developed by others (%)	3.0	7.3	0.81	0.036		
<i>Innovation intensity*</i>	process innovation (%)	87.2	82.9	-0.49	0.034		
	total innovation costs per empl. (Euro*1000)	6.88	7.19	0.44	0.804		
	R&D expenditures per employee (Euro*1000)	2.24	2.71	0.01	0.988		
<i>Type of innovation activity*</i>	Total R&D exp. on total innov. Costs (%)	34.7	42.4	0.05	0.071		
	External R&D/total R&D (%)	13.8	20.2	0.07	0.005		
	Investments/total innovation costs (%)	23.4	24.7	-0.08	0.002		
	Non-R&D exp. / total innov.costs (%)	41.9	33.0	0.00	0.127		
<i>Patents*</i>	Per cent of innovating firms with a patent application	43.4	42.7	-0.30	0.096		
<i>Information sources*</i>	Per cent of innovating firms attaching importance to:						
	universities	16.7	12.6	-0.57	0.018		
	R&D inst.	11.5	9.8	-0.48	0.089		
	suppliers	24.7	18.3	-0.34	0.102		
<i>Objectives of innovation*</i>	relevance (average scores on a 1-3 scale)						
	substitute products &/or enter in new markets	1.69	1.90	0.16	0.034		
	improve quality &/or fulfilling reg. & stand.	1.93	1.95	0.04	0.532		
<i>Cooperation*</i>	Per cent of cooperating firms	29.7	37.8	0.13	0.451		
	- with clients	8.9	11.4	0.10	0.747		
	- with suppliers	8.7	7.3	-0.51	0.148		
	- with universities	13.0	13.8	-0.54	0.077		
	- with other R&D inst.	5.4	4.5	-0.72	0.087		
	- world-wide cooperation**	8.2	16.7	-	-		
<i>Export prop.</i>	Export/turnover (%)	34.8	35.3	0.01	0.426		

Source: the authors.

Variables in bold are those for which significant differences have been found when controlling for sectoral and firm-size compositional effects.

* Figures referring to a sub sample of 584 innovating firms with valid data for all indicators.

** With firms and institutions located in a continent different from the head office residence.

These estimates confirm that the greater innovativeness of foreign affiliates found by the simple comparison of aggregate average values was due to composition effects. In fact, when the latter are controlled for, foreign affiliates do not show a (statistically significant) higher propensity to innovate (INNO). Neither are significant differences found in the case of innovation intensity indicators. The amount of resources (per employee) devoted by foreign affiliates to innovation (INEXP), and in particular to R&D (RDEXP), are not significantly higher than the resources spent on the same activities by domestic firms. On the contrary: the average propensity to patent (PAT) is higher among domestic firms than foreign affiliates.

However, the results confirm that foreign affiliates tend to rely more than domestic firms on innovation developed externally to the firm (INPDT3) and on the acquisition of R&D services (RDEXTY), and both these features are likely to be due to their technological linkages with the parent companies, regional headquarters and other firms in their groups. Foreign affiliates devote a higher share of their financial resources to R&D (RDY), while domestic firms rely more on the acquisition of technology embodied in new capital equipment and the introduction of process innovation.

Finally, external linkages (as measured by the importance attached by firms to external sources of information) are less frequent and important in the case of foreign affiliates than in the case of domestic firms, and this is true both for the interactions with suppliers of equipment, materials and components (SSUP) and for linkages and interactions with science-based institutions such as universities (SUNI) and research institutes (SGMT). This is confirmed by the indicators measuring attitude towards cooperation. This result reflects the expected lower propensity of foreign affiliates to cooperate locally with universities and research institutions.

A sectoral picture

The results of the regression estimates presented in table 4 highlight some “stylized” features of foreign affiliates which

hold across (most) industries and firm size classes. However, the innovation profile of foreign affiliates might also be affected by industry specificities that are worth examining, focussing on those dimensions of innovation activities for which generalized differences between foreign affiliates and domestic firms have not been found.

Accordingly, in table 5, foreign affiliates and domestic firms are compared at the industry level, taking into account the propensity to innovate (INNO), the amount of resources devoted (for each employee), respectively, to all types of innovation activities and to R&D (RDEXP), and the percentage of firms that has indicated universities and other R&D institutes as being important information sources (SUNRD).

The comparison made on the basis of the first three indicators in table 4 shows that, although at an aggregate level foreign affiliates are only slightly more innovative than domestic firms, sharp industry differences between the two groups of firms do nonetheless emerge. In most technology-intensive industries, domestic firms seem to be more innovative than foreign affiliates, the exception being office machinery and chemicals. In most hi-tech industries, domestic firms outperform foreign affiliates in terms of total innovation spending per employee; the gap increases in terms of R&D expenditures. An opposite pattern characterizes medium and low innovative industries, including the most traditional industries such as textiles, footwear, wood and furniture.

These findings confirm the importance played by contextual conditions (strength of the host country) in affecting the innovation strategies of foreign affiliates, in particular their commitment to undertaking R&D locally. Taking into account the technological weakness of the Italian economy in science-based industries (Malerba, 1993; Ferrari *et al.*, 2004), it is not surprising that FDI in these industries is undertaken in order to strengthen their knowledge assets or to develop new products. This interpretation is also supported by the comparison of foreign affiliates and domestic firms on the basis of the last indicator

Table 5. Innovation performances of foreign affiliates (FA) and domestic firms (DOM), by industry

Industry	Per cent of innovating firms			Total innovation expenditure per employee			R&D expenditures per employee			Per cent of firms regarding universities and R&D insit. as important information sources		
	DOM	FA	FA-DOM Per cent difference	DOM	FA	FA-DOM Per cent difference	DOM	FA	FA-DOM Per cent difference	DOM	FA	FA-DOM Per cent difference
	Food, beverage and tobacco	72.7	81.0	11.3	17.7	11.1	-37.6	4.4	2.8	-36.5	46.9	17.6
Textile, footwear, wood, furniture	48.0	60.0	25.1	9.1	15.5	70.3	1.8	4.0	118.3	11.9	22.2	87.3
Paper and printing	57.6	58.8	2.1	16.8	24.5	46.3	1.1	0.8	-23.3	11.8	0.0	-100.0
Chemical products	72.5	81.6	12.5	14.3	15.5	8.4	5.3	6.5	23.0	20.7	19.4	-6.5
Pharmaceutical products	83.3	66.7	-20.0	33.0	20.8	-37.1	21.0	8.6	-59.1	53.3	14.3	-73.2
Rubber and plastic	69.8	85.7	22.9	11.4	8.9	-21.8	2.6	2.0	-22.9	13.3	5.6	-58.3
Metals	72.0	54.2	-24.8	8.6	11.9	38.4	1.1	2.1	87.5	16.7	15.4	-7.7
Metal products	67.9	81.0	19.2	6.9	6.5	-6.9	1.7	1.2	-28.2	16.7	17.6	5.9
Mech. machinery	88.0	85.2	-3.2	11.2	7.0	-37.2	4.6	2.9	-36.8	15.5	23.9	54.7
Office machinery, electr. products	82.8	88.2	6.6	18.1	20.1	11.2	6.8	9.8	42.9	30.6	26.7	-12.7
Automobile components	66.7	82.6	23.9	15.0	11.2	-25.0	6.9	6.0	-13.6	25.0	5.3	-78.9
Other transport	69.0	66.7	-3.3	17.6	9.1	-48.3	10.3	3.7	-63.6	45.0	0.0	-100.0
Other industries	78.8	55.6	-29.5	16.7	39.0	133.1	5.2	20.0	288.6	7.7	20.0	160.0
Total	70.9	77.4	9.1	13.3	13.9	4.5	4.3	5.2	21.0	21.0	17.9	-14.7

Source: the authors.

presented in table 5: in most industries, the percentage of foreign affiliates identifying universities and R&D institutes as important information sources is lower than for domestic firms. Among the few exceptions, we find again the traditional industries and the mechanical machinery industry, the latter being another major area of excellence of Italian industry.

In brief, the results of the comparisons made between the innovation behaviours of foreign affiliates and domestic firms – presented in tables 4 and 5 – can be summarized in the following three points:

- A large part of the differences in the innovation behaviour and performance of foreign affiliates and domestic firms is due to a compositional effect, i.e. to the high concentration of foreign affiliates in the most innovative industries and to the presence of a size factor.
- Foreign affiliates and domestic firms differ from each other more in terms of their type of innovation strategies than in terms of their innovation performance.
- The innovative behaviour of foreign affiliates appears to be industry specific and influenced by contextual conditions, in particular by the technological attractiveness and strength of the local context in which the investment is made.

6. Innovation patterns of foreign affiliates: the dominant role of adaptive strategies

The empirical evidence presented in the previous section shows that the innovation strategies of foreign affiliates are far from homogeneous. In section 2 we identified (ex-ante) three stylized patterns of innovation of foreign affiliates, categorized as low-tech, adaptive and asset-seeking. In this section we use the CIS2-ELIOS database to provide empirical support for the presence and consistency of such innovation patterns. Accordingly, first we identify the main innovation patterns of foreign affiliates as they emerge from a multivariate analysis of the CIS2-ELIOS data-set, assessing also their quantitative relevance and sectoral characterization. Second, we check

whether the innovation patterns identified are consistent with our starting hypotheses (sketched in table 1) and discuss the extent to which they are affected by the peculiar features of the Italian innovation system.

Results from factor and cluster analyses

The main innovation patterns of foreign affiliates are identified by running a factor and cluster analysis on a sub-set of indicators provided by the CIS2-ELIOS data-set. These statistical techniques have been carried out using data for a sub-sample of foreign affiliates, taking into account only innovative foreign affiliates, and excluding also low-tech firms defined as an ex-ante category.⁵ The low-tech pattern has been identified by selecting firms for which at least one of the following conditions was satisfied:

- presence of process innovations only;
- introduction of innovation developed by other enterprises only;
- no R&D or design activities;
- no patent applications; and
- no interaction (through formal co-operation or informal contacts) with universities and other R&D centres.

Out of 331 foreign affiliates contained in our data-set, 106 are not innovative at all, and 47 have been classified as low-tech on the basis of the selection criteria described above. The factor analysis has been carried out on the remaining 178 foreign affiliates contained in the CIS2-ELIOS database. The list of indicators used and the results of the factor analysis are presented in tables 6a and 6b.

Tables 6a and 6b show that the factor analysis was quite effective in synthesizing the key dimensions of the innovation behaviour of foreign affiliates. Out of the nine variables

⁵ The identification of low-tech firms as an ex-ante category has yielded more robust and interpretable results of both the factor and cluster analyses, allowing us to reach a rather clear-cut demarcation between the adaptive and asset-seeking profiles.

Table 6a. Results of the factor analysis

Rotated factor matrix

	FACTOR 1 <i>Asset seeking vs. adaptive</i>	FACTOR 2 <i>Innovation intensity</i>
INEXP	0.02	0.85
RDEXP	0.11	0.84
RDEXTY	-0.30	0.09
EXPTURN	0.35	-0.10
ORADIC	-0.06	0.51
SUNI	0.68	-0.07
COUNI	0.78	0.14
CORD	0.54	0.22
GLOBAL	0.64	0.22

Source: the authors.
Note: Extraction method: Principal components analysis.
 Rotation method: Varimax with Kaiser normalization.
 Convergence criteria reached through 3 iterations.

Table 6b. Variance explained by the “components”

Component	Eigen value	Variance explained (%)	Cumulative (%)
1	2.24	28.0	28.0
2	1.53	19.1	47.1
3	0.97	12.1	59.3
4	0.93	11.7	70.9
5	0.83	10.3	81.3
6	0.67	8.4	89.7
7	0.52	6.5	96.2
8	0.30	3.8	100.0

Source: the authors.
Note: Extraction method: Principal components analysis.

KMO (Keiser Meyer Olkin) Test: 0.586
 Bartlett (Sphericity) test:
 Chi-squared (approx.) 232.3
 df 36.0
 Sig. 0.000

incorporated in our analysis, two factors were extracted; they explain 47% of total variance.⁶ More important, the first factor seems quite effective in discriminating between asset-seeking and adaptive innovation strategies. This emerges clearly when looking at the rotated factor matrix that shows the correlation coefficients between the original set of indicators and the factors extracted.⁷

⁶ The percentage of variance explained by the first two factors might be considered not particularly high. However a proper judgement of the effectiveness of the empirical exercise proposed here should take due account of the specific characteristics of the data-set used. It is a well known fact that data collected by innovation surveys are characterized by a large amount of (“erratic”) variance that is in turn due to the presence of a high degree of subjectivity in the firms’ assessment of their innovation activities and performance.

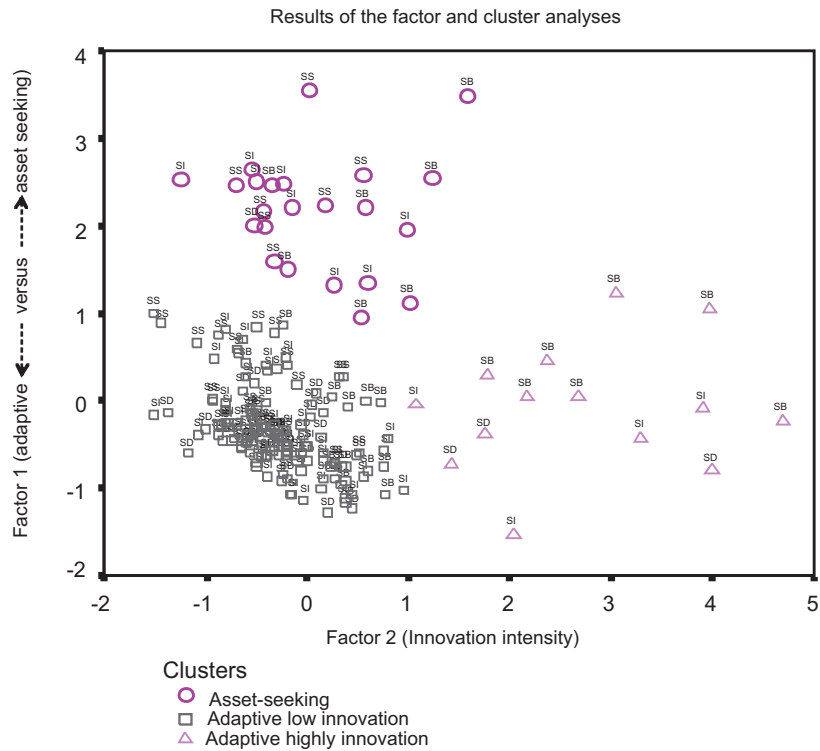
⁷ These correlation indexes increase the interpretability of the “principal components”.

The first factor is positively correlated with the importance of linkages (formal and informal) with universities and research centres, and with the variable GLOBAL, which indicates the presence of world-wide technological collaborations and linkages. The negative correlation with the acquisition of external R&D suggests that this factor also measures the presence of an endogenous R&D capacity of foreign affiliates. The positive correlation of this factor with the export propensity indicator confirms that foreign affiliates that rank high on this factor are active players at a macro-regional or global level. Conversely, firms that rank low on this factor pursue innovation strategies that are local and adaptive in scope. In brief, the first factor can be used to locate foreign affiliates along an asset seeking-adaptive strategy continuum.

The second factor measures the innovation intensity of foreign affiliates. The latter is likely to be related to the level of technological opportunity of the industry in which foreign affiliates operate, as well as to their specific attitudes towards innovation. Both these aspects are to a certain extent independent from the asset-seeking and adaptive dimension measured by the first factor. The second factor is in fact related to the total amount of resources spent on innovation (per employee), to R&D and to the importance attached by firms to strategies consisting of replacing/substituting products and entering into new markets.

In order to single out homogenous groups of foreign affiliates (and innovation behaviours) a cluster analysis was then performed using the two factors illustrated above. The clustering procedure identified three main clusters. Figure 1 allows a visualization, and first interpretation, of the three clusters. It shows the position of foreign affiliates with respect to factors 1 and 2. The vertical axis (factor 1) measures along a continuum the asset-seeking-adaptive profile of foreign affiliates, while the horizontal axis measures their innovation intensity. The industry type (à la Pavitt: i.e. science-based (SB), scale intensive (SI), specialized suppliers (SS), supplier dominated (SD)) of each foreign affiliate is also reported in the scatter-plot diagramme.

Figure 1. Innovation patterns of foreign affiliates



Source: the authors.

The three clusters shown in figure 1 can be interpreted and labelled as follows.

Adaptive clusters : less innovative and highly innovative

Two clusters are located in the bottom half of the graph. On the basis of this location, both clusters might fall under the adaptive model. They differ in terms of the average innovation intensity of foreign affiliates. In fact, among firms following an adaptive strategy, we find a large number of foreign affiliates characterized by low innovation intensity and a restricted number of highly innovative firms. We can therefore label the first cluster as “adaptive less innovative” and the second one as “adaptive highly innovative”.

Asset-seeking cluster

The third cluster is located in the upper-left side of the graph. For this reason, it can be labelled as “asset seeking”. An important aspect to be noticed is that the upper-right quadrant of the graph is empty. Surprisingly enough, there are no foreign affiliates following an asset-seeking strategy and showing a high innovation intensity. We will return below to this puzzling result.

Table 7 shows the size (number of foreign affiliates) and the industry-type composition of the four clusters identified by our empirical analysis. As expected, the adaptive patterns (and in particular the adaptive less innovative one) are by far the most common ones. The latter account for 47% of all foreign affiliates. The dominant industries in this cluster are the scale-intensive ones. It is however a light dominance (42% of foreign affiliates in the scale-intensive industries do follow such an innovative pattern, as compared to a 30% share of scale intensive foreign affiliates in the entire CIS2-ELIOS sample).

The adaptive highly innovative cluster contains only 14 firms (5% of the total), but it is nevertheless worth taking into consideration: its presence suggests that the most innovative foreign affiliates, instead of pursuing an asset-seeking strategy, concentrate their efforts on adapting pre-existing technologies and know-how (of the corporate group) to the needs of the local market. It is interesting to note that half of the foreign affiliates in this cluster belong to Pavitt’ science-based typology.

It is interesting to note that, if the low-tech and the non-innovating foreign affiliates were grouped together, they would account for 40% of total foreign affiliates. This means that 40% of foreign affiliates in our sample are characterized as either not carrying out any type of innovation activity or by a rather poor innovation performance. In terms of employees of foreign affiliates, the size of these two groups of firms is somewhat smaller, accounting for 22% of our sample.

Significantly, only 8% of all foreign affiliates pursue an asset-seeking innovation strategy. The economic relevance of

this group of firms is somewhat larger, accounting for 22% of total employment. Almost two thirds of foreign affiliates that follow an asset-seeking strategy operate in science-based and specialized suppliers industries, even though foreign affiliates in this cluster are not the most innovative of the sample.

All in all, table 7 highlights first the heavy concentration of foreign affiliates in the adaptive low innovative and non-innovative clusters, and second that the three innovative patterns identified appear to be only to a limited extent industry specific.

An interpretative reading of the clusters

The innovation profile of the four clusters identified in the previous subsection are described in detail in table 8. The table provides for each cluster the average values for the full list of indicators shown in table 4.

The picture provided by table 8 is consistent with the stylized patterns presented in section 2 and synthesized in table 1. Most of the values of the indicators reported in table 8 “behave” accordingly to our expectations. In particular, when compared to the low-tech and adaptive (low-innovative) patterns, the asset-seeking profile is characterized by innovation strategies based on strong internal technological capabilities – as emerges by the amount of resources put into the innovation process, the importance of R&D activities, the low dependence upon external R&D services, the high propensity to patent, and the radical nature of the objectives pursued through innovation. Among these factors, perhaps the most distinctive feature of the asset-seeking profile is related to the level and scope of the technological interactions established by foreign affiliates with the external environment. In this cluster, innovation activities are mostly undertaken in co-operation with other firms and institutions, and firms rely frequently on information flows coming from universities and R&D centres. In other words, our results show that foreign affiliates following an asset-seeking strategy tend to act as active world-wide technological players. In this cluster we do not find any foreign affiliates cooperating exclusively within the boundaries of the corporate group.

Table 7. Numerosity and sectoral composition of clusters of foreign affiliates^a

Cluster	No. of firms	Per cent	No. of employees	Per cent	Science based	Scale intensity	Special supplement (Per cent of firms)	Supplier dominated	Total
Non-innovative FAs	72	24	22 037	11	13	42	17	29	100
Low-tech FAs	47	16	23 262	11	13	36	21	30	100
Adaptive low innovative FAs	141	47	107 538	53	13	42	27	18	100
Adaptive highly innovative FAs	14	5	6 577	3	50	29	0	21	100
Asset-seeking FAs	23	8	43 887	22	30	35	30	4	100
Total FAs	297	100	203 301	100	16	40	23	22	100

Source: the authors.

^a The total number of foreign affiliates is different from the one presented in table 2 due to the exclusion of 21 innovating foreign affiliates with missing data on some relevant innovation variables.

Interesting enough this cluster is also populated by firms that do not belong to the typical science-based industries. This suggests that FDI might be driven by an asset-seeking strategy in a wide range of industries.

As discussed before, our analysis has revealed the presence of two distinct adaptive patterns: one characterized by low innovation performance and another one that is more innovative (adaptive highly-innovative). In line with our expectations, foreign affiliates in both these clusters are characterized by a narrower and inward-looking approach to innovation. Compared to the asset-seeking pattern, external linkages are in this case much weaker and often take the form of intra-group technology transfer (from headquarters to foreign affiliates). In particular, local sources of knowledge such as universities and R&D centres are not perceived as important by the majority of foreign affiliates. In the adaptive highly innovative cluster, foreign affiliates devote a large amount of resources to innovation. This (unexpected) feature reflects the sectoral connotation of this cluster which is composed mainly of science-based and scale-intensive foreign affiliates.

The emergence of this cluster, although unexpected, is nonetheless an interesting result that needs to be further interpreted. On the one hand, it suggests that “adaptive” and “production oriented” strategies of TNCs can be found in typical R&D-intensive industries. On the other hand, the profile of this cluster might be the result of the peculiar feature of the Italian innovation system (Malerba, 1993). There is, in fact, little doubt that the specific Italian context influences the innovation profile and size of all four clusters identified in our analysis. The large number of firms found in the low-tech and adaptive low innovative patterns is in fact not surprising, taking into consideration the relatively large size of the Italian market and its weak technological base. The same argument can be used to explain the fact that most of the foreign affiliates operating in science-based industries follow an adaptive strategy. Also the scarce presence, and relatively low innovation performance, of foreign affiliates pursuing an asset-seeking strategy might be

the result of the low technological attractiveness of the Italian innovation system.

All in all, it can be argued that the prevailing strategies of foreign affiliates in Italy are focussed on accessing a large domestic market, while asset-seeking strategies are not stimulated by the weak performance of the national innovation system nor by the presence of active innovation policies. This line of reasoning helps also to explain the presence of the white area in the upper-right part of figure 1, i.e. the lack in Italy of a pattern characterized by asset-seeking strategies and high innovative performance, as would be expected. This finding seems to be consistent also with the conclusions of section 5 based on the comparison made between the innovation performance of foreign affiliates and that of domestic firms.

These results also suggest that FDI with an asset-seeking orientation is more likely to be found in medium-technology industries where Italian firms hold a comparative advantage (i.e. in mechanical engineering and traditional industries), while the attractiveness of the country emerges as being modest, and probably decreasing, in the most typical high-tech industries. In other words, the Italian case seems to show that an “asset seeking” pattern of internationalization is a prerogative not only of TNCs operating in science- based industries. FDI might in fact be driven by asset-seeking motives also in the case of traditional industries, as long as the host country (or region) has accumulated a sufficient stock of knowledge that can be shared and exploited. This finding might suggest interesting generalizations beyond the Italian case.

7. Final remarks: country-specific factors and general findings

This article has provided fresh empirical evidence on the innovation strategies of foreign affiliates of TNCs and the role they play in a host country. The wide range of information provided by CIS has been used to assess the technological contribution of foreign affiliates in Italy, to highlight the

technological determinants and objectives of FDI and to identify the main patterns of technological internationalization of TNCs. CIS data have allowed us to assess both the quantitative and the qualitative dimensions of innovative activities carried out by foreign affiliates.

The empirical evidence presented in section 5 shows that foreign affiliates and domestic firms differ from each other more in terms of their “type of innovation strategies” than in terms of their “innovation performance”, and that the greater innovativeness of foreign affiliates depends on a double composition effect: their concentration in science-based and scale-intensive industries and their larger size. As expected, foreign affiliates tend to rely more than domestic firms on innovations developed externally and on tight technological linkages with their parent companies and with other firms of the corporate groups. At a sectoral level, more clearcut differences between foreign affiliates and domestic firms do nonetheless emerge: in the majority of technology-intensive industries, domestic firms outperform foreign affiliates, especially in terms of financial resources devoted to innovation and R&D activities, while an opposite pattern characterizes the medium and low innovative industries.

These results are fully consistent with findings from section 6: the heterogeneous nature of foreign affiliates’ innovative behaviour was further explored by carrying out a factor and cluster analysis on a selected number of indicators provided by the CIS-ELIOS data-set. We have identified three main innovation patterns of foreign affiliates labelled as “low-technology”, “adaptive” and “asset seeking”. These patterns differ on the basis of the overall commitment of foreign affiliates to innovation, the sources and objectives of the technological activities undertaken, and according to the nature, strength and geographical horizon of technological links established with the external environment.

In line with our expectations, the “adaptive” pattern is by far the dominant one. Our analysis has however revealed the

presence of two distinct adaptive patterns in Italy: one characterized by a low or medium innovation performance, and another by an “adaptive highly innovative” pattern. The emergence of the last cluster, somewhat unexpectedly, is an interesting finding. It suggests that a number of highly innovative foreign affiliates adopt user-oriented strategies to serve the domestic market, with poor linkages with the local industrial and productive milieu.

On the other hand, foreign affiliates that follow an “asset-seeking” or “global” profile, which tend to be characterized by more radical innovation strategies aimed at further strengthening their knowledge assets, show only a moderate innovation intensity in Italy. This means that the embeddedness of high-tech TNCs in the country is limited.

The empirical findings presented in this article, in addition to highlighting some stylized features of innovative strategies of foreign affiliates, also reflect the structural features of Italian industry and its innovation system. There is little doubt in fact that the specific Italian context has affected some of the features and the relative size of the clusters we have identified. The well known technological weaknesses of the Italian innovation system explain why most foreign affiliates seem to be mainly interested in gaining access to a large domestic market, while asset-seeking innovation strategies are much more rare. The attractiveness of the country seems, in fact, to be modest, and probably decreasing, in high-tech industries. This, in turn, reflects the decline, in the past decade, of the “oligopolistic core” of Italian industry, which has not been compensated for by the emergence of new innovative medium-sized TNCs in traditional industries.

The Italian case seems to suggest a more general conclusion. It shows that an “asset seeking” pattern of internationalization can be found also in traditional industries, as long as the host country (or region) has accumulated a sufficient stock of sharable knowledge. This finding could have interesting applications and generalizations for other countries,

especially those specialized and competing in low and medium technology industries. Our results, if extended to other countries, could suggest a convergence between the competitive advantages of the host economy and its innovation-based attractiveness for TNCs. More work is needed to clarify this issue through comparative analyses based on the use of CIS data for other countries, while using CIS 3 data will allow the creation of a dynamic picture of these processes. ■

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Attracting “desirable” FDI: theory and evidence

Peter Enderwick*

A precondition for successful targeting of inward investment is an understanding of its likely impacts. To date, most attempts to assess the “desirability” of FDI have concentrated on short-term first-round impacts. The analysis of the determinants of desirability has tended to focus on simple structural factors, including firm size, entry mode, nationality and stage of value-adding, or classifications based on the motives for investment or affiliate strategy.

This article draws on the literature to develop a conceptual framework of how FDI might be expected to impact on a host economy. This framework is then contrasted with one derived from a major empirical study of the effects of international investment in four emerging economies undertaken by the McKinsey Global Institute. A number of similarities and differences are noted. The most significant difference between the two frameworks is the importance attributed to competitive pressure in the empirical study. The article also identifies a number of ambiguities associated with the concepts of investment targeting and desirability including endogeneity (the interaction of policy interventions and perceived desirability), sensitivity to the types of, and motives for, investment, and the complex effects of policy interventions.

Key words: FDI attraction, investment impact, targeting

* Peter Enderwick is a Professor of International Business, Faculty of Business at the Auckland University of Technology (peter.enderwick@aut.ac.nz). The author would like to thank three anonymous referees for useful comments and suggestions.

Introduction

There is considerable empirical support for the belief that foreign direct investment (FDI) is playing an increasingly important role in the world economy. FDI inflows as a proportion of gross fixed capital formation increased from just over 2% in the 1970s to almost 5% in the early 1990s (UNCTAD, 1999). Total sales of the foreign affiliates of transnational corporations (TNCs) reached \$17.5 trillion in 2003, some two and a half times higher than the level of world exports (UNCTAD, 2004). Foreign affiliates of TNCs accounted for 11% of world GDP in 2001, compared with 7% in 1990 (UNCTAD, 2002). The growing significance of FDI has important implications for a range of economies seeking growth and development. This is the case for developing, developed, and transition economies.

FDI can play a significant role in the development process (UNCTAD, 1999). Although the critical inputs to development are still viewed primarily in terms of the key factors of production – land, labour, capital, technology – the context within which these are effectively utilized has changed dramatically. In particular, increasing knowledge content, the growing mobility of factors, strong competitive pressure to attract FDI and widespread liberalization, have all impacted on the nature of the development process. This, in turn, has required host developing countries to consider carefully investment in appropriate assets and infrastructure, the coordinated integration of a range of policies (not just those directly affecting international investment), and the avoidance of expensive incentive competition to attract FDI.

Developing or transition economies have used FDI to supplement investment resources, to transfer much needed technology and organizational and managerial skills, to upgrade quality and productivity, and to gain improved access to world markets. More generally, inflows of FDI have stimulated the development of markets and the supporting regulatory infrastructure essential to their efficient working (Child and Tse, 2001; McMillan, 1993).

The competition to attract inward FDI by a wide range of economies has resulted in a number of responses. First, there have been widespread policy changes – more specifically, a marked trend towards the liberalization of regulatory frameworks (UNCTAD, 1999). Second, competition for FDI has contributed to the growing provision of incentives and inducements (Mytelka, 1999). Third, for a number of economies, the desire to avoid extreme competition has encouraged more selective targeting. Ireland is an example of a country that has increased its focus on particular industries, and even particular companies within those industries.

It is this area of selective targeting that is addressed in this article and, particularly, the idea that FDI varies in its “desirability”. “Desirability” appears to be generally interpreted as relating to the magnitude of likely impacts, specifically, economic impacts. A variety of bases for determining desirability have been suggested. A common feature is that they are generally built on simple dichotomies, such as the size of firm (larger firms are thought to be more desirable than smaller firms), industry (higher value-added is preferred to lower value-added), the functional focus of an affiliate (higher order functions such as research and development (R&D) or regional headquarters are preferred to assembly operations), the form of entry mode (greenfield investment is superior to mergers and acquisitions), or the orientation of a firm (Poynter and White, 1984). While the simplicity of such distinctions may appeal to policymakers, they are unlikely to provide meaningful insights into the complex issue of assessing the impact of FDI.

This article attempts to go beyond these simplistic approaches and provides the foundations for a more robust and comprehensive framework for assessing the desirability of FDI. It offers a contribution in three key ways. First, it provides a summary of current understanding of the possible impacts of FDI, bringing together direct and indirect impacts as well as three types of impact – primary, secondary and tertiary. Second, this analysis is then subjected to exploratory testing using the

findings of a recent study on international investment in developing countries (MGI, 2004). Third, the discussion raises a number of issues with regard to what the terms “targeting” and “desirability” mean, including the endogeneity problem of targeting where the impact of FDI depends, at least in part, on the policy framework that exists within a host economy. In this way, appropriate policy can increase the perceived desirability of FDI if it facilitates the attainment of policy goals.

To achieve these purposes, the article is organized into five principal sections. The next section summarizes the literature on approaches to FDI desirability and targeting. This is followed by a discussion and development of a more comprehensive framework for investment assessment. The fourth section develops an empirically based framework drawing on a recent large-scale case-based study. The following section contrasts the two frameworks and develops some of the implications of the findings for maximizing positive impacts and enhancing development. The final section offers conclusions.

Approaches to determining desirable FDI

As suggested above, attempts to define the desirability of FDI have focused on its likely economic impacts. In particular, because of the difficulties of the precise measurement of impacts, the majority of studies have confined themselves to first-round (or primary) impacts. Primary or first-round effects are the aggregate benefits and costs that accrue to an economy as a result of the bundle of resources brought by the investing firm. These effects include employment creation, capital inflows, the provision of technology and the transfer of new managerial and organizational practices.

Such effects are (comparatively) easy to define, and since they tend to manifest themselves largely within the short term, their measurement is more straightforward. This focus has resulted in attempts to try to identify particular types and forms

of FDI that are most likely to deliver the desired effects. We can identify several distinct sets of defining criteria that have been applied.

The first group relates to simple structural characteristics, including the size of the investing firm, the type of FDI in terms of value-adding, investor nationality, mode of market entry, and export-orientation. For many policy-makers there appears to be a preference for attracting larger investors, perhaps because of the expected considerable impact of such firms, a belief that larger firms are more robust or stable, or from a desire to attract perceived industry leaders. Larger TNCs can certainly have a major impact on an economy. For example, in Costa Rica, Hungary and Mexico, the largest three TNCs account for 29%, 26% and 13%, respectively, of total exports (UNCTAD, 2002). While size may be positively correlated with primary impacts, it appears to be negatively related to secondary impacts (which result from spillovers from foreign affiliates to local firms) and the development of linkages in the local market (Barkley and McNamara, 1994; Schachman and Fallis, 1989). Differences in the value-adding stages of FDI have also been used to judge desirability. The general belief is that higher value-added activities have a more significant impact and, hence, are more desirable.

The desirability of activities is also related to the level of a country's factor endowments and development. While a simple, labour-intensive assembly plant may be appropriate for a developing country such as China, Singapore seeks to attract higher-order functions such as R&D, strategic planning or financial management. Evidence on investor nationality is mixed. While early studies asserted that behavioural differences by nationality of investor resulted in differential impacts (Kojima, 1978), the globalization of business strategy means that such differences are unlikely to persist. More recent work suggests that nationality differences may serve as proxies for geographical or psychic distance (Driffield and Noor, 1999; Rodriquez-Clare, 1996).

The mode of entry also has a mixed effect on economic processes, depending on whether one considers primary or secondary impacts. Since greenfield investments normally bring a significant inflow of additional resources, their primary impact is likely to exceed that associated with acquisitions.¹ However, the situation may be reversed in the case of secondary impacts where, in the case of acquisitions, acquiring companies are likely to inherit local linkages that may have been established over a considerable period of time (Scott-Kennel and Enderwick, 2004; UNCTAD, 2000). The attraction of export-orientation as an indicator of investment desirability follows from the powerful links between economic openness, trade and growth. But the attraction of export-oriented investment is not based solely on its growth, or balance-of-payments effects. Rather, there is growing evidence that export-oriented FDI can play an important dynamic role in shifting and upgrading, over time, the productive structure of host economies (UNCTAD, 2002).

A second approach, which attempts to go beyond simple structural characteristics, focuses on the motives for FDI and relates these to expected impacts. John H. Dunning (1993) provides a widely used classification based on four primary motives: resource-seeking, market-seeking, efficiency-seeking and strategic asset seeking investment. The different motives for investment could imply differential impacts and the need for appropriate locational advantages if positive impacts are to be maximized. For example, resource-seeking investment is likely to have strong primary impacts as complementary ownership advantages are attracted to a host economy, but secondary impacts through the development of linkages may be low. Tertiary impacts on the general level of a country's infrastructure or utilization of natural resources may be more significant. In contrast, strategic asset seeking investments may occur in the form of acquisitions with limited primary impacts but stronger secondary effects where ownership advantages are transferred through collaborative arrangements.

¹ Provided that the crowding out effects of a greenfield investment are not significant this is likely to be the case. See UNCTAD (1999).

There is an element of dynamism underlying this approach when it is recognized that changes in the world economy, in particular declining costs of coordinating and integrating international business activities, have favoured a shift towards efficiency- and strategic-asset seeking FDI (Dunning and Narula, 1997).

A third and related approach, which draws on the strategy of TNCs and, in particular, the orientation or role of foreign affiliates, has a considerable legacy. The early studies emphasized the stage of development of a TNC, its likely strategy and its international orientation (Keegan, 1995; Perlmutter, 1969; Poynter and White, 1984). These characteristics and orientation were then related to likely impacts. For example, a TNC at an early stage of development was thought likely to display an ethnocentric orientation and operate a centralized strategy with affiliates taking the form of miniature replicas. Local sourcing and, hence, linkages, were expected to be low. Clearly, this approach is based on an incrementalist view of internationalization which delineates distinct, sequential stages of development.

Such an approach is less valuable in a dynamic global economy with declining information and transaction costs. Similarly, it also fails to recognize that a TNC's corporate strategy may provide the mechanism to incorporate and upgrade country-specific locational advantages within globally integrated international production systems that bring considerable dynamic competitive advantages (UNCTAD, 2002). More recent applications have applied strategy concepts such as the integration-responsiveness paradigm to identify the role of foreign affiliates and, from this, likely impacts (Jarillo and Martinez, 1990; Taggart, 1996; Liang and Nicholas, 2002).

While this approach is based on an essentially static typology, it does highlight the likelihood of shifts in the roles of foreign affiliates over time and, perhaps most importantly, of the need to relate locational advantages to their roles.

It is only a short step to a fourth approach which is currently being emphasized (UNCTAD, 2001), one that links the desirability of FDI to selective targeting designed to meet development goals. This approach is distinctive in a number of ways. First, rather than simply trying to relate TNC strategy or affiliate role to locational conditions, there is an attempt to link desired FDI to explicit development objectives. Such a view is based on the recognition that FDI is a means to an end and not an end in itself. The purpose of FDI, from the perspective of a host country government, is to contribute to competitiveness growth or development goals.

Second, neither the terms of an investment nor locational conditions are taken as given; both can be subject to policy intervention and manipulation. Effectively this means that the desirability of an investment project becomes endogenous.² At the most fundamental level there is a recognition of the distinction between the gross and net desirability of an investment. The difference between these two is accounted for by concessions such as incentives that may have to be provided to attract FDI. In this case, the relative bargaining strengths of the two parties – the host country government and the investing TNC – become relevant. At a more sophisticated level, targeting may focus on a limited number of competitive industries, a matching of investor assets and host country resources or the underlying sources of competitive advantage such as the facets of Michael Porter's diamond (Dunning, 1992). There is some evidence that targeting specific desired outcomes may be more effective in maximizing economic impacts than focusing on input variables such as firm or industry characteristics (Driffield and Noor, 1999).

Third, an effective targeting strategy is dynamic and should be capable of incorporating changing developmental goals as

² I recognize that investment desirability may also be a co- or joint product, that is, interactions between policy and the characteristics of the investment may increase desirability. A simple example would be where a government coordinates the supply of immobile assets with the specific needs of a proposed investor.

an economy evolves. While a targeting approach appears to offer considerable benefits in maximizing the developmental impact of FDI, it is subject to a clear limitation that arises from the endogeneity of desirability. To target appropriately, a government needs to be able to assess desirability. Thus, a targeting approach needs to be guided by a clear understanding of the likely impacts of various investments. That is the purpose of the framework summarized in the following section.

Development of the conceptual framework

Figure 1 summarizes the framework. Start by considering the current rate of economic growth and level of development of an economy. This influences the policy priorities of the country's government and, in particular, what it seeks to obtain from FDI. At the same time, a country's rate of growth and development level also in part determine the attractiveness of the economy as a location for FDI.

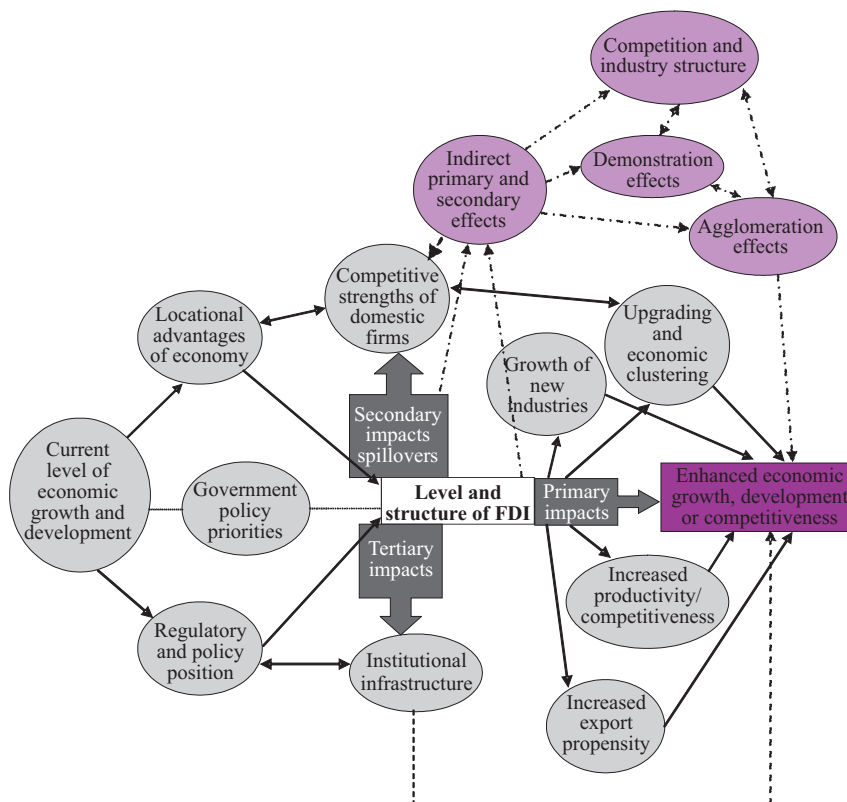
The two principal determinants of locational attractiveness identified in the model are the locational advantages of an economy and its regulatory and policy position. Locational advantages are well developed in the literature (Dunning, 1993) and encompass both simple factors such as natural resource endowments or market size, as well as created assets, including skilled labour, technological capability and infrastructure.

A country's regulatory and policy position is also likely to influence the level and structure of inward investment. FDI may be discouraged by what investors perceive to be overly onerous regulations or restrictions. This seems to have been the experience of India in the late 1970s and early 1980s. Similarly, policies that encourage particular entry modes such as joint ventures influence both the level and type of FDI received. An FDI policy that includes an element of targeting is likely to lead to a narrower range of foreign-owned activities within a country.

The combination of the locational advantages of an economy and its policy stances are the key determinants of the

level and type of FDI received. It is also notable that there is, in this framework, a two-way linkage between the locational advantages of an economy and the competitive strength of domestic firms. The assumption is that domestic firms draw competitive advantages from the locational assets of the economy, e.g. low cost labour or opportunities to process natural resources, in ways that may complement or compete with the aims of foreign investors. The activities of local firms influence the attractiveness of an economy in the eyes of foreign investors where domestic firms may be seen as complementary to the activities of foreign investors (suppliers, joint venture partners), or they constitute a potential asset (perhaps where resources

Figure 1. The impact of FDI in theory



Source: the author.

are under-utilized or managed inefficiently, or have unique and valued capabilities).

There is also a link between the regulatory and policy position of a country and its institutional infrastructure. Effectively, this captures the degree of policy effectiveness and credibility. Successful and consistent policy implementation is likely to be positively related to the level of institutional development. Similarly, as the level and sophistication of institutional infrastructure increases, more complex and discriminating policy options become possible.

The level and type of FDI that is attracted has various impacts on a host economy. The model distinguishes three principal levels of impact. The magnitude of each depends on a number of factors, the most important of which include the entry mode adopted, the assimilative capability of an economy and the policy environment of a host country.³

Direct effects

Primary impacts that result from ownership advantages and resources brought by foreign affiliates affect the rate of growth, development level or degree of competition directly in a number of ways. The first is the possibility of developing entirely new industries or activities. Examples include computer chips and pharmaceutical products in Ireland or clothing products in Sri Lanka and Mauritius. Where such activities displace declining industries, provide opportunities for higher value-added or enable industrial diversification, they may upgrade economic activity.

A second direct primary impact operates through increased export propensity. The growth and development impetus of export industries means that they offer considerable potential benefits. In addition to overcoming various domestic market

³ There may be dynamic or aggregation effects that influence the impact of FDI and that are not captured in the model. These will be considered in the subsequent discussion.

constraints, such industries are subject to the competitive discipline of competition in world markets. The reality of breaking into such industries, particularly those based on high levels of technology, means that TNC involvement may be both desirable and necessary (UNCTAD, 2002).

A third direct primary effect shown in figure 1 is increased productivity or competitiveness of resource use. This effect follows from the belief that TNCs bring both distinctive resources as well as the possibility of more efficient resource use. Differences in the economic, social and political contexts of home and host countries determine the distinctive nature of the bundle of resources transferred by a foreign investor. Such differences can enhance productivity through innovative combinations of foreign and local resources. Furthermore, the ways in which resources are utilized may differ as a result of their incorporation within a transnational production system (Dunning, 1992). There is considerable empirical evidence suggesting that the productivity performance of foreign affiliates is generally higher than that of uni-national local firms (Caves, 1996).

The fourth form of direct primary impact occurs through upgrading and economic clustering. It is important to distinguish these effects from those that occur through spillovers to local firms (secondary effects). In the case of direct primary upgrading and economic clustering, foreign investors engage in activities not available to domestic firms, perhaps because of a lack of technology, know-how or market awareness. An example is provided by the New Zealand forestry industry which was able to upgrade into the processing of medium density fibreboard following the importation of the necessary know-how by Japanese investors. The establishment of medium density fibreboard processing also fostered an important economic cluster linking wood processing, adhesive suppliers and fabricators.

As figure 1 shows, upgrading and economic clustering are linked to the competitive strengths of domestic firms. This occurs because domestic firms may provide the foundation for

upgrading (perhaps because of the prevailing underutilization of resources) and the critical mass for successful clusters. In turn, local firms may also benefit from the entry of foreign investors into similar or related industries.

The secondary direct impact of FDI occurs through the development of linkages and demonstration effects. As the figure shows, the principal route for such effects is through domestic firms.⁴ As domestic firms benefit from spillovers or demonstration effects, they add to the locational advantages of the economy and contribute to economic clustering and upgrading. The determinants of secondary or spill-over effects are complex (UNCTAD, 2001b).

The tertiary⁵ impacts of FDI are likely to affect economic outcomes indirectly. Their principal influence is through the formation and development of institutional infrastructure. These effects are of particular value to least developed countries and transition economies. In turn, the development of a country's institutional infrastructure can contribute to policy options and effectiveness as well as more directly to economic efficiency. More generally, FDI can assist the integration of a host economy into the world economic system and helps maintain its openness (Sachs and Warner, 1995).

Indirect effects

In addition to their direct impact on a host country's economy, FDI may also have indirect effects. Impacts of this type are difficult to measure and, as a result, have not been given much consideration in desirability and impact studies. They may,

⁴ This mechanism is implicit within the Investment Development Path model (Dunning and Narula, 1998) whereby inward investment contributes to the competitive advantage of domestic firms which, in due course, may become outward investors.

⁵ Tertiary effects refer to the cumulative impacts of FDI and may manifest themselves as changes in the structure or nature of an industry, institutional development or enhanced national competitiveness.

however, be significant and, as a result, need to be incorporated into robust decision-making.

Figure 1 shows three key indirect effects stemming from both primary and secondary impacts. The first, and often the most significant, relate to effects on competition and industry structure. The entry of foreign investors to an existing industry may have a sizeable impact on the structure and level of competition. The magnitude and relevance of this impact depends, in turn, on the mode of entry, regulatory policy and the bargaining strength of the investing firm and the host country government. All other things being equal, greenfield FDI is likely to have a more significant impact on structure and competition than an acquisition. Indeed, in a number of transition economies many of the benefits of privatisation have been lost where a private (foreign) monopoly simply replaces a State monopoly. Strong anti-trust policy may also be necessary to ensure that the full competitive effects of FDI actually materialize. Such policies should not distinguish between domestic and foreign firms; rather they should simply focus on maximizing the welfare-enhancing effects of competition.⁶ The likelihood of such policies (or their effective application) is related to the bargaining power of the two parties. Powerful TNCs may bargain for competitive relief (perhaps in the form of import restrictions, limits on the number of competitors or assured markets) as a precondition for investment. In such a case, the net desirability of the investment is likely to be less than the gross expectation.

The second indirect impact occurs through demonstration effects. In such a case, the activities of foreign affiliates provide valuable knowledge to domestic firms. Unlike direct impacts that are transferred through linkages, demonstration effects occur in a more nebulous fashion. A good example is provided by the

⁶ Clearly this does not mean simply maximizing the number of competitors in an industry as the relationship between structure and welfare is more complicated than this. Similarly, it may be necessary to distinguish between short-run (allocative) and long-run (dynamic) effects of competition.

international interest in Japanese production methods such as quality circles, just-in-time production and team work which was apparent in the 1980s. The adoption of such approaches by Western firms occurred primarily through the demonstration of apparent benefits rather than direct transfer between linked organizations.

The third indirect impact of FDI on an economy's performance occurs through the creation or strengthening of business clusters and the agglomerative economies that may be enjoyed by all firms, both domestic and foreign. Such effects are of particular importance in high-technology activities where there is evidence of the value of close physical association. For many advanced economies, this type of impact may be of considerable value since it both enables and encourages further specialization, which is fundamental to high-value production.

Figure 1 shows that the three indirect effects are related: this suggests that an economy may experience several effects simultaneously. For example, demonstration effects may be particularly strong within clusters, reinforcing agglomeration economies. At the same time, indirect effects feed back into the impact on the competitive strength of domestic firms. It is apparent that direct and indirect effects can be both substitutes and complements. The most desirable situation is when they operate in a complementary fashion. In this case the skills and resources of foreign investors are transferred directly to local firms through a variety of linkage forms; at the same time, these skills may be emulated by unrelated firms.

A relationship of substitution could occur where foreign firms eschew direct linkages (perhaps because of policy restrictions, the level of competitive assets held by local firms or the existence of considerable cultural gaps). In such a case, the diffusion process is likely to be slower, less significant and biased towards generic and non-proprietary skills. This is likely to mean a reduced impact on growth, development and competitiveness in the short term.

Exploratory test of the framework

In this section I offer a tentative testing of this framework, drawing upon the detailed case studies reported in MGI (2004). This study used an extensive case study approach to explore the impact of FDI in five industries in four emerging markets – Brazil, Mexico, India, China. These countries provide a useful test platform. All are large economies and are at different stages of economic development, with Brazil and Mexico enjoying income levels about twice those of China and India. Their economic experience has also been different: China has grown rapidly, while growth in Mexico and Brazil has been characterized by a high degree of volatility. Their policy environments also display diversity. China has placed considerable reliance upon State-owned enterprises, Brazil has followed an import substitution strategy, India has suffered from pervasive regulation, and Mexican liberalization has been driven by NAFTA membership in 1994. All have moved in recent years to liberalize FDI and have been successful in attracting international investment. Over the period 1995-2000, China attracted the most investment – a cumulative total of \$209 billion, some 70% more than Brazil, three and a half times the level in Mexico, and sixteen times more than India. The contrast provided by two Asian and two Latin American economies enriches the analysis.

We utilize part of this study, the auto industry experience in the four countries, to test the framework shown in figure 1. The auto industry is one that many developing countries seek to establish. It is characterized by considerable scale economies, high capital requirements, a modest rate of technical change, and high tariff levels. For these reasons it is dominated by large TNCs. Within the auto industry, the impact of FDI is largely a result of its integrative nature, and particularly the integration of capital, technology and skills. The MGI study found the overall impact of auto FDI to be positive in all four countries. I provide a summary overview of the four countries and principal findings in table 1.

Table 1. Summary of auto industry FDI impacts: Brazil, Mexico, China, India

Variable	Brazil	Mexico	China	India
<i>Liberalization</i>	From early 1990s, re-established tariffs 1995.	Imports liberalized 1990.	Limited.	Partial in 1983, subsequently in 1993. Still ongoing.
<i>Market size</i>	Tenth largest vehicle producer. 1.7m units in 2002.	Ninth largest vehicle producer. 1.8m units in 2002.	721,000 units in 2001.	More than a half million units.
<i>Type of firms</i>	All foreign investors.	All foreign investors. Top 5 firms have 90% of the market.	Three waves of FDI. VW/Beijing Jeep mid-1980s. Peugeot/Suzuki mid-1990s. GM, Honda, Nissan, Ford late 1990s. Good key domestic firms.	1983 Suzuki entered market. Since mid-1990s most major OEMs entered.
<i>FDI motives</i>	Market seeking (tariff jumping).	Early FDI market seeking (tariff jumping) More recently 70% efficiency seeking; 30% market-seeking.	Market seeking.	Market seeking.
<i>FDI forms</i>	100% greenfield.	100% greenfield.	100% joint ventures with State-owned enterprises.	Joint Ventures 82%; greenfield 18%. Most Joint Ventures subsequently majority foreign owned.
<i>Markets/exports</i>	75% domestic to rest of Latin America.	70-80% exports to North America.	Majority to domestic market. Limited exports.	10% of production now exported.
<i>Capacity changes</i>	1.85m units in 1995. 3m in 2001. Capacity utilization in 2002 = 55%.	1.3m units in 1994. 2m in 2001. OEMs increased capacity by 50% 1994-2000. Full utilization due to United States market.	Sales increased from 455,000 units in 1995 to 721,000 in 2001.	More than half a million units. 13-fold increase since 1983. 40% excess capacity.

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Table 1. Summary of auto industry FDI impacts: Brazil, Mexico, China, India (continued)

Variable	Brazil	Mexico	China	India
<i>Labour productivity growth</i>	Strong.	Strong.	Strong.	Increased almost four-fold 1993-2001.
<i>Value added growth</i>	Modest.	High.	High.	-
<i>Employment trends</i>	Modest decline.	Very small growth.	Very small growth.	Stable.
<i>Adjustment processes</i>	Exit of weak firms. Upgrading of incumbents. Importance of competitive pressure.	Increased specialization and rationalization. Spillovers to the components industry.	Direct effects (operational improvements and economies of scale). Indirect competitive pressure.	Exit of weak firms. Upgrading of incumbents. Both direct and indirect effects.
<i>Productivity increased through</i>	Automation in old plants. Creation of new plants.	Incremental investment in existing plants. Increased specialization and rationalization.	New FDI by OEMs. Increased efficiency through transfer of best practice and increased economies of scale.	Infusion of new capital and technology. Increased productivity in incumbent firms. Emergence of a components industry.
<i>Economies of scale</i>	Increased product diversity limits scale economies.	Units per model produced increased from 24,000 to 58,000 1995-2001. Reduced diversity in production (consumer choice increased due to imports). Little shift in market shares.	Some increase.	Many sub-optimal plants.
<i>Imports/exports</i>	-	17% of all United States vehicle imports in 2001, up from 8% in 1994.	Exports of FBU vehicles small. Some export of components. Imports subject to 25% tariff on FBU vehicles.	Major importer of components.

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Table 1. Summary of auto industry FDI impacts: Brazil, Mexico, China, India (concluded)

Variable	Brazil	Mexico	China	India
<i>Sectoral spillovers</i>	Structural changes in components manufacture but productivity growth less than in vehicle assembly.	Structural changes in components manufacture but productivity growth less than in vehicle assembly.	OEMs invested directly in components industry.	Components industry has more than tripled in size. Significant OEM outsourcing. FDI by major international component makers, increasing quality and reliability.
<i>Domestic firms</i>	Last one exited early 1990s.	-	Very small and weak.	Exit of PAL in early 1990s.
<i>Profitability</i>	Declined for veteran OEMs. Poor for new entrants. (competition and market volatility).	-	High. Above expected risk adjusted rate of return.	Declined. A clear link between market share and profitability.
<i>Gap to best practice</i>	Medium.	Medium.	High. Average productivity at 13 joint ventures just 21% of United States levels.	Very high. Historically, domestic producers highly protected. Restrictions on FDI and imports persist.
<i>Impact of FDI has been</i>	Positive.	Very positive.	Positive (limited by low levels of competition).	Very positive.

Source: the author, based upon MGI (2004).

Using the data summarized here, figure 2 summarizes the impact of FDI in the auto industry in Brazil, Mexico, India and China. While there are clearly differences in experience between these four countries, there are sufficient commonalities to derive figure 2.

Discussion of the two frameworks

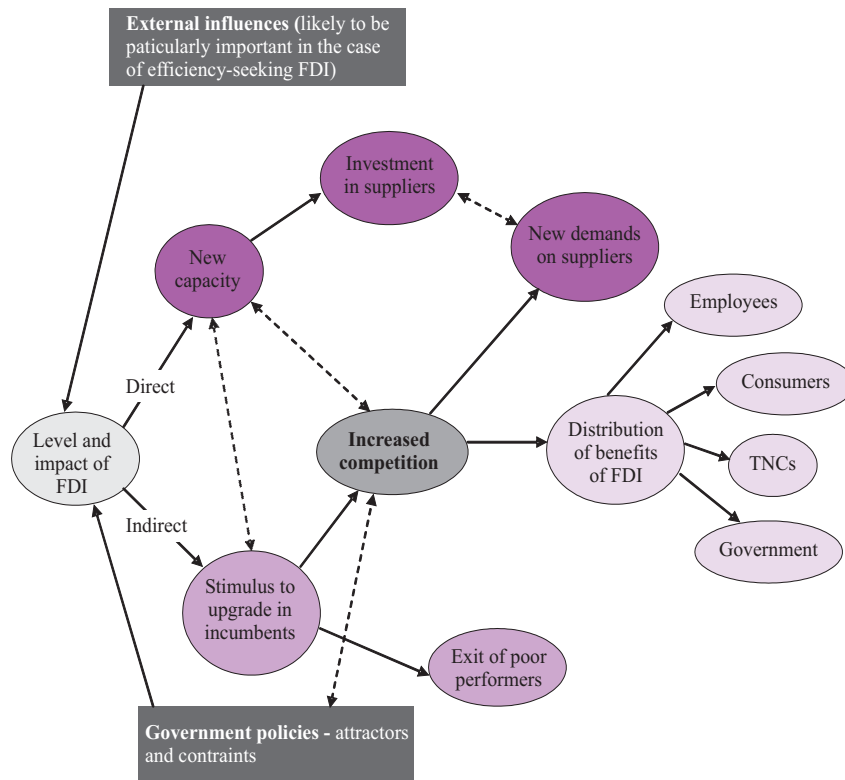
When the conceptual framework of figure 1 is compared with the empirically-based figure 2, a number of similarities and differences become apparent.

In terms of similarities, three main points are noteworthy. First, both frameworks identify direct and indirect impacts. The direct impacts are a reflection of the volume of FDI received and the conditions under which this is assimilated. For both approaches, competition and the ability to establish minimum scale or critical mass are significant influences on direct impacts. Indirect impacts are also central to both frameworks. The primary indirect impact occurs through spillovers. However, some differences in emphasis are apparent. The empirical framework emphasises the importance of spillover effects on incumbent firms and foreign-owned suppliers. Conceptual approaches tend to focus on spillovers to indigenous competitors and suppliers. Furthermore, it is competitive pressure that drives spillover effects in the empirical work. This is in addition to the linkage mechanisms (joint ventures, technological cooperation etc.) that are normally emphasized in conceptual thinking.

Second, the mechanisms by which the effects of FDI are diffused are broadly similar. For both frameworks, the drivers of increased productivity are automation, innovative management practices and the adoption of superior technologies. There are some differences in the underlying determinants of productivity improvements. In conceptual thinking, the motive is generally opportunities for increased profits. The empirical work highlights the need to upgrade simply to survive in the face of intense competition.

Third, both frameworks identify the importance of the entry mode and the motive for investment as significant determinants of the impact of FDI. For example, case studies of Mexico highlight the importance of efficiency-seeking investment. Such investment has encouraged specialization and rationalization. This has enabled producers to achieve economies of scale. At the same time, trade in finished vehicles has increased both market competition and consumer choice. Where the principal motive for investment is market seeking, and this is coupled with restrictions on imports (the situation in China), TNCs face lower levels of competition and excess profits may persist.

Figure 2. The impact of FDI in practice: the auto industry in four emerging economies



Source: the author.

Differences between the two frameworks are striking. There are important differences in locational advantages, the role of government policy and the recipients of the benefits of FDI. The empirical analysis emphasizes the centrality of government policies. In the conceptual framework, it is government priorities with regard to growth and development goals that are stressed. Similarly, the empirical work focuses more on the locational advantages of the (automobile) industry as opposed to country advantages. This probably more accurately reflects the decision-making process followed by large TNCs, particularly industry-specific businesses such as vehicle producers. A further difference is apparent in that the conceptual approaches emphasize the stimulus to domestic firms; empirical thinking, certainly in an established global industry dominated by large TNCs, also includes the shock effect experienced by incumbent firms.

Second, the case results highlight the criticality of economies of scale and not simply industry restructuring. In part this is linked to the importance attributed to the level of competitive pressure experienced by both new investors and established firms. In turn, the degree of competition is largely attributable to government policy decisions with regard to import restrictions, incentives and local content requirements. Competitive pressure is the driver of change and improvement in the case work, not simply absorptive capability of domestic businesses and presumed linkages between international and local firms. The degree of importance assigned to competitive pressure is perhaps the most important difference between the two frameworks.

Third, the empirical work gives greater emphasis to the distribution of the effects of FDI and how this impacts consumers, producers, employees, and government. In the four case countries examined, consumers are the principal beneficiaries. Similarly, the empirical work pays scant regard to the tertiary impacts of FDI, emphasizing primary and secondary impacts.

I recognize that this testing of the conceptual framework is, at best, exploratory. There are obvious limitations with any single industry study, and one that encompasses four very different emerging economies. Furthermore, the distinctive characteristics of the automobile industry – importance of economies of scale, domination by a small number of global TNCs, high levels of foreign ownership and control of the upstream supply industry – limit the generality of the empirical framework. Nevertheless, despite these limitations the contrasts do highlight our limited understanding of what determines the impact of FDI and how policy-makers can maximize the desirability of inward investment.

Conclusions

This article developed a conceptual framework for understanding the impact of FDI based on relevant literature. It was then contrasted with empirically-derived case evidence for the automobile industry in four emerging economies. A number of differences between the two frameworks can be discussed. The most important relates to the role of competition. In the case studies, the level of competitive pressure is the key determinant of both the magnitude and the distribution of the benefits of FDI. A number of conclusions can be drawn.

First, it is apparent that the conceptual literature on attracting desirable investment places a far greater emphasis on investor characteristics than does the empirical work which highlights the importance of the investment environment and policy regime. Of particular importance is the role of competition-related policy. Clearly, both investor characteristics and the business climate are important. For policy-makers, it is worth noting that different policy interventions are likely to have complex and perhaps contradictory effects. For example, import restrictions may increase the amount of inward investment due to tariff jumping, but the subsequent effect of limiting competition is likely to reduce the impact of an investment as well as the distribution of the benefits.

Second, the idea of “desirability” is a problematic one. There is clearly an endogeneity or joint-production problem: policy interventions determine, at least in part, FDI impacts. This means that desirability cannot be assessed independently of the investment climate. The focus in much of the conceptual work on investor characteristics needs to be supplemented with a consideration of the circumstances in which a firm’s competitive advantages are applied.

Third, generalizations regarding the desirability and impact of FDI are sensitive to both the type of, and motives for, investment. This adds to the complexity of effective FDI targeting.

Finally, there also appears to be some confusion regarding the meaning of FDI targeting. In the conceptual literature, targeting focuses on specific industries or firms in an attempt to build critical mass in new industries, deepen clusters or introduce new skills and technology. In the empirical work considered here, targeting is equated with the provision of incentives and other inducements. Clarification of the precise meaning of a targeted approach would be helpful.

In summary, the discussion offered here suggests that there is a significant gap between our understanding of how we think we maximize the desirability of inward investment and what happens in practice. If, as suggested by UNCTAD (2003), there is a need to emphasise the developmental benefits of FDI, we need a clearer understanding of effective targeting and what determines the desirability of international investment. ■

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NAFTA Chapter Eleven and the implications for the FTAA: the institutionalization of investor status in public international law

Noemi Gal-Or *

Two issues have emerged from the innovation spurred by the investment chapter (Chapter 11) of NAFTA which provides for the settlement of investor-State disputes outside of the State's domestic courts. First, it represents the recognition that the legal standing of the natural and/or corporate legal person, when acting in the economic capacity of investor, is equal in international law to that of the State. Second, the inclusion of a private party-State alternative dispute resolution mechanism in an intergovernmental treaty is contradictory to the voluntary commitment by parties to such an agreement underlying this method, known as "privity of contract". These innovations have given rise to challenges in international public law, particularly given the strong influence that this NAFTA alternative dispute resolution mechanism has exerted on many intergovernmental bilateral investment treaties and free trade agreements. If the Free Trade Area of the Americas, which is modelled on these developments, is adopted, then this will complete the institutionalization of the investor-State alternative dispute resolution innovation. It is not too late to review and debate in an in-depth manner this possibility in order to secure consistency within international public law.

Key words: dispute resolution, subject of international law, NAFTA, FTAA, privity of contract.

* Director, Institute for Transborder Studies, Kwantlen University College, Surrey, British Columbia, Canada. The author is grateful to three anonymous referees for their valuable comments and to the Kwantlen University College librarian Margaret Giacomello. Contact: Email noemi.gal-or@kwantlen.ca.

The views expressed in this article are those of the author and do not necessarily reflect the views of the United Nations.

“There is a newly emerging tyranny attempting to suppress democratic discourse about issues of economic policy that are vital to prosperity...”
(Stiglitz , 2002, p.10)

1. Introduction

Joseph Stiglitz, former chairperson of President Clinton’s Council of Economic Advisors and subsequently Chief Economist of the World Bank, bemoans the decade-long economic policies of the United States administration for laying “the groundwork for some of the problems we are now experiencing” (Stiglitz, 2002, p. 3). Stiglitz advises that the corporate scandals of the 1990s serve as a chief reminder that “... government has an important role. Every game has to have rules, and government sets the rules of the economic game. *If the rules promote special interests*, or the interests of corporate executives, then the outcomes are not likely to promote general interests, or the interests of small shareholders” (Stiglitz, 2002, p. 7, emphasis added).

This article draws attention to a set of rules that promotes the particular interests of investors.¹ These rules represent a development in international law that raises a myriad of new questions and challenges. The transformation of the General Agreement on Tariffs and Trade (GATT) into the World Trade Organisation (WTO) contributed an array of definitions concerning firms and private parties (reflected in the WTO agreements) and confirmed that firms and private actors were often considered “units of account”² in trade and investment activity. There is, therefore, a need to clarify the legal status of these actors. It is in this regard that the North America Free Trade Agreement (NAFTA) and not the WTO,³ has played a

¹ The State inviting investment also has interests that are reflected in this set of rules. This article focuses on the rules that serve the interests of the investor and, to the extent that the interests diverge, does not discuss the issue from the State’s perspective.

² The author is indebted to an anonymous referee for this formulation.

³ In which private actors do not have standing.

pivotal role and exerted a strong influence. Since NAFTA, the increased usage of investor-State dispute resolution mechanisms within intergovernmental bilateral investment treaties (BITs) (Mann et al., 2004; Waelde, 2004a) and free trade agreements (FTAs) has been impressive. It allows the investor to seek settlement of investor-State disputes outside the State's domestic courts, or any domestic court for that matter, through alternative dispute resolution (ADR) mechanisms – specifically, but not exclusively, arbitration. Furthermore, NAFTA's influence on regional FTAs is unmistakable. The negotiations of the Free Trade Area of the Americas (FTAA)⁴ (that may result in a future regional agreement⁵) reflect acceptance of the spirit of its NAFTA forerunner. Combined, NAFTA's influence on BITs and bilateral trade agreements, on the one hand, and on regional free trade negotiations, on the other hand, illustrates an institutionalization of these legal developments, suggesting that they have become common standards.

Two issues have emerged from the innovation spurred by Chapter 11 of NAFTA, which deals with the issue of investors. First, the State, which is the only subject of international law with a right of standing⁶ in disputes arising from intergovernmental accords, has *de facto* recognized the natural and/or corporate legal person – when acting in the economic capacity of investor – as an equal subject of international law,

⁴Throughout, the article refers to the third draft FTAA.

⁵ Although declared “dead” by many commentators, the recent endorsement of the NAFTA by the American National Association of Manufacturers (NAM) and Brazil's Federation of the Industries of the State of Sao Paulo, which just signed a memorandum of agreement reiterating support for the FTAA (NAM, 2005), and the 2004 reaffirmation by the heads of State of Canada and Brazil of their commitment to the FTAA (Government of Canada, 2005) tend to suggest otherwise. The FTAA may, however, take the shape of a *de facto* web of FTAs linking various States together in a “spaghetti bowl” mix of treaty provisions rather than one detailed and explicit regional treaty framework.

⁶ The State is to be distinguished from other international actors, e.g. non-governmental organizations (NGOs). These enjoy a new legal status in international law as participants in the process of international law adjudication and making, however not as subjects of law equal in legal status to the State. See WTO (1998).

on par with governments. Second, the State adopted long ago ADR mechanisms to substitute for court litigation as a means to resolve its disputes. ADR mechanisms, however, are based on the principle of mutual consent, i.e. their application is dependent on the voluntary agreement signed between the parties to it that is referred to as “privity of contract”.⁷ In introducing the investor as party to the ADR mechanisms, with rights and duties as complainant or respondent, but not as party to the treaty or to an arbitration agreement, the drafters of international law have been moving away from a principle fundamental to the logic of a dispute resolution system that distinguishes itself from court litigation.

This article suggests that the time is opportune for thoroughly addressing and debating these issues because the negotiations of the FTAA have not yet been concluded, and its reconsideration is still possible. Also, due to its importance,⁸ the ramifications of either adoption or revision of the investor-State concept in the FTAA will have considerable influence on the future evolution of public international law.

Section 2 discusses the history and purpose of international commercial ADR in order to contextualize the main argument, namely that the draft FTAA may represent the final stage of confirming and sealing the institutionalization of NAFTA’s Chapter 11 in public international law. Section 3 explains the innovation introduced by Chapter 11’s investor-state ADR mechanism and section 4 discusses its implications for international law. Section 5 investigates the implications emerging from the interpretation of international law by the Canadian courts;⁹ section 6 describes the FTAA Investment Chapter (Chapter 17) ADR provisions; and section 7 concludes.

⁷ This may differ from domestic law where arbitration has been legislated as a means to resolve disputes concerning the public good (e.g. in disputes between labour unions and employers) or where government guarantees, assurances or certification are involved (e.g. insurance, construction) and regarding administrative law at large.

⁸ It would represent the world’s largest free trade area.

⁹ Which serves an example for the implications of Chapter 11 for domestic law.

2. The history and purpose of international commercial ADR

For over a century, ADR (notably arbitration¹⁰) has figured as a major tool of choice to resolve economic disputes, and arbitration has been seen as playing a significant role in economic and political affairs. International ADR has its roots in medieval commerce, but contemporary international commercial ADR began only in the late 19th and early 20th centuries with the use of mixed claims commissions¹¹ that attempted to resolve State-to-private-party (or State-owned companies) disputes. In the 1980s, the practice of by-stepping court litigation in favour of ADR expanded. ADR was considered an ingredient of a pre-emptive strategy designed to minimize investment risks particularly in developing countries. Foreign investors were increasingly assured protection through State contracts concluded between governments and the private sector (Bjorklund, 2001), as well as in inter-governmental BITs. The provisions for dispute resolution adopted in these accords represented mostly “soft law”, and formed part of the re-vitalized doctrine of *lex mercatoria* (or merchant law) (Cutler, 2003).

Figuring as an important factor in the process of economic globalization, ADR has indeed carved out a private justice system within international trade law shadowing, and competing with, the court system. In United States terminology, it was coined as “offshore litigation” (Dezalay and Garth, 1996, p. 173), a new type of justice service engaging different classes and political positions. The argument in favour of international commercial¹² (i.e. involving a private party) ADR identifies numerous disadvantages associated with litigation via the court system at either the national or international level. Domestic litigation has been said to entail disadvantages such as time, cost (capital and personal), limitations regarding personal

¹⁰ Among the various ADR tools are facilitation, consultation, negotiation, mediation and arbitration and various combinations thereof.

¹¹ For example, in cases of nationalization of private oil companies in the Middle East.

¹² “Commercial” denotes private-to-private and State-to-private business relationships, while “trade” infers State-to-State commerce.

jurisdiction, and subjection to a judicial process in foreign courts with differing legal systems. Furthermore, private sector concerns about the potential non-enforceability of foreign judgements resulted in unpredictability and uncertainty, thereby threatening commercial stability. All this was seen to cumulate into a “general chilling effect on international business transactions” (Naranjo, 1996, p. 118) resulting from court litigation and considered as a great disadvantage to the conduct of international business.

In addition to the private sector’s dissatisfaction with the system of justice, trading States were looking for mechanisms to supplement or substitute for the weakness of the International Court of Justice (ICJ).¹³ For a long time, governments relied on the GATT dispute settlement rules, which they later refined in the 1995 WTO Dispute Settlement Understanding (DSU) governing also intellectual property and service trade disputes. Along with the WTO Appellate Body, the DSU has represented a more viable and effective law enforcement option than the GATT and ICJ. Thus, in a consistent evolutionary process, ADR, and particularly arbitration, adapted from the international private sector,¹⁴ has shifted the resolution of disputes arising under public international law out of the public arena of the courts and into the private arena of tribunals. In the process, many legal inconsistencies were created, which remain unresolved. These include the status of the investor in international law and the teleological foundations for ADR investor related provisions incorporated within public international trade law.

The discussion of international ADR involves the distinction between “hard law, soft law, and softer law or extra-legal standards” (Mistelis, 2001, p. 16) which represent different aspects of public international law, including commercial law.

¹³ For example, in the settlement of intellectual property rights disputes (Hertz, 1997). Its weakness was related, among other things, to its lack of power to enforce judgments.

¹⁴ And the domestic adjudicative sphere wherein it developed rapidly in the post-World War II era.

“Hard law” comprises international conventions, national statutory law and regional and international customary law reflecting the traditional axiom that international law is the system of law primarily regulating the relations between and among States and traditionally known as “public” international law (Parry, 1968, p. 1). “Soft law” comprises model laws, legal guides and scholarly “renditions” of international commercial law, all of which are not incorporated into national law, as well as private contractual terms that do not conflict with public policy. Soft law is legally binding and enforceable only upon consent of the parties. “Softer law” comprises extra-legal standards used for the purpose of assessment of legal questions (e.g. product quality measurement codes – Mistelis, 2001).

Lex mercatoria, a more recent category of rules permeating public international law, is also the most indeterminate source of public international law, still in the process of crystallization. While NAFTA is a binding treaty ratified through implementing legislation by each of its signatories, and BITs are similarly intergovernmental agreements, the dispute resolution provisions of *lex mercatoria* emerging in NAFTA,¹⁵ BITs and possibly a future FTAA, have their origins somewhere in-between soft and softer law – a category yet to be determined. Indeed, as soft law became incorporated within hard law (e.g. the United Nations Commission on International Trade Law (UNCITRAL) *ad hoc* arbitration rules model law or the World Bank’s International Centre for Settlement of Investment Disputes (ICSID) Additional Facility Rules), the question arose whether this practice sufficed to transform the nature of soft law and “codify” it into hard law when incorporated in treaties.

ADR has gained high regard within the legal profession, business and government – and to a certain extent (depending on sectors and interests) – also in the public eye. It has successfully mobilized the symbols of the public justice system

¹⁵ Note that, even within NAFTA, ADR remains partly dependent on the judiciary (e.g. for the enforcement of arbitral awards or mediated settlement agreements, or where the impartiality of an arbitrator is at stake).

in legitimizing the out-of-court dispute resolution concept and its mechanisms. The overall outcome has seen judges acting sometimes as mediators, as senior partners to lawyers on both sides of the dispute or as counsellors to the parties, and employing skills that are not unique to judges alone. The ensuing economic opportunity for the legal and para-legal professions has nourished the emergence of over 120 arbitration centres and more general ADR service providers (Dezalay and Garth, 1996). Yet, from a theoretical legal perspective it has been observed that "... the recognition of a 'private enclave' within the official justice system ... clashes with law's universal ideology" (Dezalay and Garth,¹⁶ 1996, p. 118) representing a dilemma that remains to be resolved. One way to illuminate this issue is to engage in a close examination of the incorporation of elements from *lex mercatoria* within public international law (Berger, 1996) which is "relatively permanent and independent of individual states, in that it is not subject to any ratification" (Mistelis, 2001, p. 23).

3. The innovation introduced in public international law by NAFTA's Chapter 11

Because of NAFTA's importance,¹⁷ its Chapter 11 has become the spearhead of a reformative – perhaps revolutionary – front in intergovernmental trade agreements. This has been explicitly recognized by professionals sceptical of the Chapter's intent of, and ability to, protect investors (IISD and WWF, 2001, p. 6), and who maintained that "[u]ltimately, the chapter came to include stronger elements of investor protection and liberalization than found in the Canada-U.S. Free Trade Agreement, or in any existing BIT" (International Institute for Sustainable Development & World Wildlife Fund, 2001, p.8). Also, the Government of Canada has implicitly expressed reservation noting that:

¹⁶ Bryan Garth is past President of the American Bar Association.

¹⁷ While some investment agreements predate NAFTA, most of today's BITs and FTAs, which include investment provisions, were signed after, and were predisposed to follow in the path of NAFTA. This gives an additional reason to consider NAFTA's Chapter 11 as the banner for new international trade agreements.

[t]he mere fact that Chapter 11 has generated so much widespread commentary – whether based on deep analysis or pure emotion – indicates that something is seriously wrong with the status quo and signals pressing unfinished business within the NAFTA framework (cited in Alexandroff, 2004, p. 463).

Underscoring the novelty of Chapter 11 is the fact that, unlike the WTO DSU and many other previous international legal ADR provisions included in earlier FTAs and BITs,¹⁸ it reformulates the investment relationship. These provisions, which stipulate a binding dispute settlement mechanism between the investor and the State, are of unprecedented nature¹⁹ (IISD and WWF, 2001) and supplementary to terms addressing investment disputes between the contracting parties. Ever since NAFTA, Chapter 11 has been reflected (in varying measures) not only in many BITs (e.g. in all United States BITs) but also increasingly in FTAs (in a comparatively limited version in the European Energy Charter), the sub-regional Treaty on Free Trade between Columbia, Venezuela and Mexico, the bilateral free

¹⁸ UNCTAD documents the existence of over 2,000 BITs by 2005, of which 1,800 were concluded concurrently with/or after NAFTA, many of them between developed-developing and developing-developing countries. Between 1994 and 2005, Canada alone has signed over two dozen (Alexandroff, 2004; Waelde, 2004b). To be sure, ICSID was established in 1966 precisely to regulate disputes between a State and a private party. These investments, however, were largely of a “concession” type contract designed to address investment risks in a Cold War climate (Waelde, 2004a). Moreover, “it is recognized that international law enforced by investment arbitration tribunals can not become a supranational legal system for the infinite number of government procurement and other contract disputes just because foreign operators are involved;” and the footnote to this statement adds that “[t]his theme is repeated in many recent arbitral awards ..., but is rarely thought through: Formally, investment arbitral tribunals are never supranational appeals body [*sic*], but from a more material perspective, they provide – as appeals do – a recourse to judicial decision-making when the domestic option either appears non-appealing or in some cases when the domestic recourse has failed to satisfy the aggrieved investor” (Waelde, 2004a).

¹⁹ In large measure due to the enlarged scope of the possibilities open to an investor seeking recourse, which have turned the legal protection of the investor into a double-edged sword – protective shield but also sword (IISD and WWF, 2001).

trade agreements between Bolivia-Mexico, Costa Rica-Mexico, Canada-Chile (SICE, 2003) and most recently in the United States-Chile Free Trade Agreement (USCFTA, 2004).²⁰ All these agreements provide for terms addressing investment disputes arising between a contracting party and an investor and permit the investor to bring a claim against a government in an arbitration procedure. This represents a salient novelty in intergovernmental agreements, for two reasons: investment provisions now draw into their realm the broader context of the trade (not just investment) agreement within which they are incorporated (prior to Chapter 11, similar provisions were related to specific issues and were limited in scope); and they allow for binding arbitration initiated by an investor.

The rationale for enhanced foreign investor protection agreements was based on the expectation that such protection, while encouraging investment in developing economies, would also provide opportunities for investment and encourage job creation in the home country of the investor (Mann, 2002, pp. 2-3). Recent studies show that BITs have not led to these effects (Mann *et al.*, 2004), although NAFTA members more than doubled their foreign investment in their NAFTA partners between 1994 and 2000 (Government of the United States, 2003a). In addition, stakeholders and commentators have been vocal in criticizing Chapter 11's ADR provisions for causing harm to social interests (i.e. labour and the environment), for interference with national sovereignty and for undermining the democratic rules of the game at the national and sub-national levels of government. Furthermore, according to these critics, alongside the foreign investment gains, evidence has been mounting of unintended side effects in the form of foreign investors' recourse to the new ADR protection hindering government efforts to implement measures aimed at improving public welfare, through environmental legislation for example.²¹

²⁰ The USCFTA is the first comprehensive free trade agreement between the United States and a South American country.

²¹ "Since the adoption of the high-profile NAFTA, many of these uses are now directed at blocking or seeking compensation from government measures designed to protect the environment or public welfare in other areas, but which impact upon an investor's interests" (Mann *et al.*, 2004, p. 1).

Subject of international law. The extensive focus on the adverse labour and environmental impacts of Chapter 11 has overshadowed its larger and deeper reaching implications on international law. What Chapter 11 has effected – without much public debate – is the addition of a new subject of international law to its already expanding list of new subjects.²² Chapter 11 is innovative because it does away²³ with the more than century old international legal principle that the government of a State is the only subject that has (full) standing in international public law and is representing its citizens in its governmental capacity.²⁴ Intergovernmental trade and investment agreements (unlike commercial contracts²⁵) are instruments of public, not private, international law. With this development, governments have now allowed (solicited) the investor to become a direct subject of international law since, under certain conditions stipulated in the investment dispute resolution mechanism, the investor is entitled in law to file directly – not via representation by government – a complaint against a foreign government. Concerned by the fact that international investment law is endowing its new subject – the investor – with rights and no corresponding responsibilities (by definition, a subject of international law carries both rights and duties), Howard Mann, like other critics, has protested against “the absence of a sense of basic justice in such a system of law” (Mann, 2002a, p. 2).

Privity of contract. The logic of ADR, which distinguishes it from adversarial court litigation, is premised on the mutual consent given by the parties that have concluded an

²² This has been noted by experts on human rights; see the discussion by Alvarez (2004). More generally, on the expansion of the definition of subjects of international law, see Petersmann (2002) and Rights and Democracy and ICCLRCJP (2000).

²³ More than any other similar provision (e.g. Article 26 of the European Energy Charter, 1991).

²⁴ Even in matters of human rights (the most progressive development to date is the International Criminal Court), the party against which a natural or corporate legal person may submit a petition, is a natural person, not a State (IISD and WWF, 2001).

²⁵ See Waelde (2004a).

ADR agreement. The question which therefore arises from Chapter 11 is, whether an investor, who is not party to an international public trade or investment treaty, may be considered as having expressed consent to the procedure. Is actual recourse to the ADR provision sufficient proof of voluntary acceptance? Since, as private parties, investors cannot negotiate the ADR terms of a treaty, their only choice remains acceptance or rejection of the agreement “as is”. Rejection, however, will not lead to a more attractive alternative.²⁶ Unlike the State, which has negotiated the ADR provisions adopted in the agreement, the investor is in a weaker bargaining position, or has none at all. But even if the very option of having recourse to ADR satisfies the test of free consent, the investor still will not be legally bound by the treaty. Or, is it now the case that, according to this scenario, proof of voluntary acceptance of the treaty’s ADR terms renders an investor a party to the inter-governmental agreement? Arguably, while such a position is sustainable from a *lex mercatoria* contract law based perspective, it is significantly less persuasive when approached from a public international law angle.

Human rights and international trade law. “Through the transfer between contexts the meaning of norms becomes contested as differently socialized actors apply them. The analytical challenge is to provide a methodological link between these practices” (Wiener, 2003, p.1).²⁷ Expanding the definition of the subjects of international law requires overcoming the analytical challenge – a task that has characterized the discourse on human rights law, but only marginally the discussion of the re-definition of the subjects of public international law in an economic context. In the debate between Philip Alston and Ernst-Ulrich Petersmann, the latter maintains that his “proposals for empowering individuals” pursue the same human rights values as Alton’s through decentralized and more complex “market

²⁶ After all, distrust of the local justice system in a host country formed one of the original reasons to incorporate ADR provisions in investment agreements.

²⁷ Boehmler (2004) provides an interesting philosophical contribution to the analysis of the issue.

governance mechanisms which treat citizens as legal subjects rather than mere objects” (Petersmann, 2002, p. 8). In contrast to mainstream discourse, the political is distinguished from the economic, social and cultural spheres of human rights. Petersmann emphasizes the “mutual synergies between economic integration law, human rights and social welfare” because “[e]conomic welfare depends on constitutional guarantees for the division of labour, savings, investments and trade among individuals and on the protection of human rights” (Petersmann, 2002, p. 6).

A “social market economy” hinges on reconciling liberal and social values through legislative protection, where international economic law includes procedural rights in addition to substantive rights. This would require one to “suggest [interpret] national and international guarantees of freedom, non-discrimination, rule of law and social justice (e.g., in the Bretton Woods and WTO agreements) in a mutually coherent manner as empowering citizens, obliging governments and reinforcing individual rights (e.g., to ‘negative’ as well as ‘positive freedoms’, non-discrimination and individual access to courts)” (Petersmann, 2002, p. 3). In other words, against the backdrop of Petersmann’s argument, the innovation of Chapter 11 might be viewed as a first step towards the enfranchisement in international law of the individual legal person in their capacity as an investor and beyond – encompassing all economic matters. If and when the human rights debate extends beyond the intellectual backroom and is positioned in the political forefront, the extension of the definition of the subjects of international law embarked upon in Chapter 11 may well prove not just innovative but revolutionary indeed.

Chapter 11 developments ten years later. Recurrent calls for increased public access to the process of negotiation and implementation of NAFTA effected a minor drift in this direction when almost ten years after its entry into force, governments have begun paying attention. Both Canada and the United States are now committed to having their hearings in public (provided the arbitrating investor agrees). The NAFTA

Free Trade Commission took the unprecedented initiative of issuing a joint interpretive statement designed to clarify key aspects of its dispute resolution mechanism for the purpose of future arbitrations. The October 2003 statement promised that the parties would take greater steps to share documents filed in connection with Chapter 11 proceedings with members of the public and other levels of government, in the hope of alleviating fears and concerns created by the procedure (Tollefson, 2002, p. 186). The Commission's decisions have led to the establishment of a procedure for *amicus* briefs submissions,²⁸ and have also paid attention to the separate concerns of the private sector (private party-to-private party) by accepting the recommendation of the NAFTA Advisory Committee on Private Commercial Disputes and calling for a harmonized legal framework for the resolution of private commercial disputes (Government of the United States, 2003a). All of this, however, still leaves the core element of the NAFTA investor-State dispute resolution formula (i.e. privileged extension of the definition of the subjects of international law and privity of contract) intact.

4. The implications of Chapter 11 for international law

The reach of Chapter 11's innovations extends beyond international trade, commerce and investment, or labour interests and environmental concerns. It further amplifies earlier changes (in human rights law) that have been modifying the architecture of international law, and in particular the distinction in international law between public and private disputes. Comparing trade and investment liberalization in NAFTA with that under the agreements of the WTO or the European Union (EU) illustrates the magnitude of this evolution. WTO members have not reached agreement about negotiations on investment and the DSU governs only State-State disputes.

²⁸ Representing a reinforcement of the WTO Shrimp decision. The NAFTA's three trade ministers agreed "on measures to further improve the transparency and efficiency of Chapter 11 (Investment) dispute settlement process, including guidelines for submissions from non-disputing parties and a standardized Notice of Intent Form" (Government of Canada, 2003b, p. 1).

However, the European Court of Justice (ECJ) has carved out an approach for the EU that reconciles features of both international and national law. It chose to follow the classical theory of representative democracy and to apply it as a standard measure to secure adherence by EU institutions to democratic principles.²⁹ Most ECJ cases reflect jurisprudential attention to questions of institutional balance within the EU, and provide lessons to be learnt with regard to the “osmosis” (Ninatti, 2003) permeating the EU’s regional and national levels. It is widely accepted that the ECJ’s deliberations have affected the conceptualization of the EU as a regional integration area, a proposition that is foreign to NAFTA’s adjudicative process simply because NAFTA lacks the relevant institutions. Consequently, although it has served as a model for providing investment-related ADR mechanisms, the course that international trade and investment law has taken in the 1990s, and which has been influenced by the innovations introduced in NAFTA’s Chapter 11, reflects an only partly conceptualized approach. The investment aspect of *lex mercatoria* has not yet been integrated within the theory of international law.

It has been inferred in defence of Chapter 11 that – similar to *lex mercatoria* at large – it represents the evolutionary process of law (Berger, 1996; Cutler, 2003). Moreover,

the investment law now emerging is that the process of norm development is no longer an exclusively inter-governmental project. Rather, it deploys the legal procedures developed in the largely privatised systems of commercial arbitration and itself mediates between the traditional inter-governmental character, and the new privatised character, of investment arbitration, with ‘legal entrepreneurs’ providing impetus and dynamics (Waelde, 2004b, p. 478).

Some advance this argument as grounds to embracing the change: “we are not straying into the unknown, but rather are

²⁹ Accordance with democratic principles is also a guiding tenet of NAFTA.

correcting the aberration manifested in the nationalization of international economic and business law during the 19th century ... we are merely returning to our roots ...” (Jan Dalhuisen cited in Waelde, 2004b, p. 478). However, one must question whether in the context of a globalized 21st century environment, such an approach remains applicable to an increasingly complex socio-political post-modern order. Arbitration, which is the hallmark of the Chapter 11 investor-State provisions, is, according to Michael Reisman (1992, p. 1) in fact, “a delegated and restricted power to make certain types of decisions in certain prescribed ways. Any restricted delegation of power must have some system of control. ... Controls are necessary not only for efficient operation. Effective controls are the only assurance of limited government. In this sense controls are a *sine qua non* of liberty”. How does this assertion apply to trade liberalization that empowers the investor? Is the limitation on government as emerging from Chapter 11 contributing to control?

In Chapter 11, the issue of control relates to the designation of arbitration as a mode of dispute settlement involving two different types of subject of international law – the State and the investor. To fulfil its purpose, control must address the core characteristics of the subject of control. As mentioned above, in the EU, European institutions (specifically the European Parliament) are the beneficiaries of the ECJ’s judgments, and the context for the Court’s interpretation is designed to assure a democratic balance within the regional institutional system. In NAFTA, where delegated representation remains at the level of the national parliaments of the members and there is no regional NAFTA body to counter-balance the executive, control will remain elusive. Chapter 11 provisions that have expanded the definition of the subjects of international law to include only certain (not all) actors in the market place (i.e. the investor), are insufficient to secure against unlimited control by the economically powerful. It rewards the powerful corporate investor, but leaves other actors outside the scope of protection (Gal-Or, 1998a, 1998b, 2002). This has been recognized in the debate regarding public goods – of which the State has

traditionally been the guardian. According to Michael Hart and William Dymond quoted in Alan Alexandroff (2004, p. 469):³⁰

States face a choice. One option is to retreat from obligations governing the treatment of foreign investors and investments. ... A better choice would be to extend rights of private access beyond investment issues to encompass the full range of international economic exchanges and to expand access to those rights to their own citizens, corporate or otherwise.

Chapter 11 fails to satisfy the control requirement for yet another reason: it overlooks the central role played by privity of contract in the very mechanism of arbitration. It transposes “arbitration rules [that] were created to remove investment disputes from the heated political arena of state-to-state controversy to the cooler ... tribunal” (Laird, 2001, p. 225) and places them within the arena of investor/private party-to-State disputes, but with an unclear legal or political grounding. The conversion of a private contract law based principle into a treaty law context has not been thought through adequately. From a political perspective, State-private party relations involve a set of implications different from those arising in a State-to-State relationship. Consequently, from a legal point of view, Chapter 11 contributes to self-contradictory norm development (regarding investor-State disputes) – which applies not only at the point of initiation of the arbitration procedure but also at the stage of judicial review of an arbitral award.³¹ For instance, clearly the argument that investor-State arbitration under NAFTA is invalid becomes irrelevant in the context of Chapter 11 because “none of the bases for invalidity common in the commercial arbitration context, such as coercion, fraud, lack of identity of the parties, and so forth, can apply where arbitration is ‘without privity’ ...” (Jan Paulsson, cited in Rubins, 2004, p. 363).

³⁰ See also Rubins (2004) and IISD and WWF (2001, pp. 19-20).

³¹ Under UNCITRAL, which is referred to by NAFTA (Rubins, 2004).

The insights gained in the EU may provide guidance for NAFTA signatories as well as the drafters of the FTAA,³² particularly due to the role played by the adjudication process in the transformation of norms. As observed in the EU, it is significant that “often, jurisprudential affirmations appear to prefigure those normative reforms to which the treaties have conformed throughout the history of European integration” (Ninatti, 2003, p. 5). The ECJ has become “a privileged interlocutor, a concrete starting point for understanding the affirmation of democratic principle in European integration” (Ninatti, 2003, p. 5), even a “privileged ‘political’ agent” (Ninatti, 2003, p. 5). To be sure, it is reasonable to expect that the adjudication process within NAFTA may yield a similar influence. This is all the more important when considering the role that the national courts of NAFTA signatories may play in recognizing foreign arbitral awards.

5. The national court as an agent in mediating the impact of Chapter 11: Canadian examples

Which institution plays the role of “privileged political agent” with regard to the NAFTA area? Arguably, by analogy, the international-national law “osmosis” proposition may also be valid with regard to NAFTA. In such a case, the osmosis will be effected through a combination of NAFTA arbitration panels of the one hand, and United States, Canadian and Mexican national courts on the other, which, through judicial review, would be performing a role similar to that of the ECJ. The Canadian example serves to illustrate this proposition.³³ Not surprisingly, and in contradistinction to the ECJ, the Canadian court has adopted a deferential attitude to international adjudication. The literature on the role of judges in the domestic internalization of international law, and the jurisprudence

³² Although NAFTA and (a possible future) FTAA are both free trade agreements and do not establish a common market.

³³ This article discusses only a limited number of examples to show the reach of arbitral decisions under the “evolving law” of Chapter 11 as they reverberate within international law and affect domestic law.

regarding the implementation of international law by Canadian administrative tribunals, is relevant here.³⁴

For instance, the part of the decision in *Baker* (*Baker v. Canada*, 1999) discussing the Court's method of interpretation to determine whether to incorporate international legal norms in domestic law is illustrative of a relatively new trend in Canadian courts. The question raised in *Baker* was whether to substitute the teleological interpretation of laws, which was based on legislative intent and historical origins, with a more engulfing contextual ("non-originalist") and persuasive approach. Shifting to the latter, the Court endorsed a broad construction, undertaking to consider all national indicators that could suggest approval of international conventional law (Houle, 2003, p. 4). According to this approach, interpretation depends not only on the literal text of the international norm, but equally incorporates both axiological and empirical contexts of the norm (Houle, 2003, p. 7).³⁵ The implications are significant. Since *Baker*, a judge may no longer be required to examine the conformity of national and international law, for a simple ascertainment of compatibility will suffice; and in the absence of conflict between international and national laws, the judge will remain free to give effect to the former in the latter's laws (Houle, 2003, p. 7).

Another example of the deferential approach to international law is the *Metalclad* decision³⁶ (Government of

³⁴ Although only one example addresses trade and international commerce directly, the insights from the literature and jurisprudence are suggestive of an overall trend relevant also to international trade and commerce law.

³⁵ It should be noted that *Baker* applies to the incorporation of international law through an administrative agency based on the latter's discretion and pro-active orientation. Nevertheless, it is argued here that this signals a general pattern regarding the incorporation of international law within national law, particularly in the absence of unequivocal decisions to the contrary in non-administrative issues.

³⁶ A NAFTA Chapter 11 appeal heard by the Supreme Court of British Columbia, Canada. See also Rubins (2004, pp. 375-380).

Canada, 2001). Mexico, supported by the Intervener Attorney General of Canada, urged the Court to review the traditional judicial deferential approach to private commercial arbitral awards. The grounds advanced by Mexico were based on the principle of privity of contract, i.e. the argument that Chapter 11 represented a departure from that principle since the investor was not party to the treaty within which the dispute originated. In this example, the Court deferred to the NAFTA tribunal without clear explanation (Rubins, 2004, p. 376).

Considering the Court's positions in both cases – regarding the arguments challenging the transposition of international within national law (*Baker*), or those concerning the interference of private, within public, international law (*Metalclad*) – suggests that, in practice, the Court prefers to follow, rather than “struggle” to resolve complex issues arising in international law. Consequently, it could be inferred that Canadian judicial deference to international law might be signalling a tendency to go beyond simple judicial reluctance to interfere with international law on a legal plane. The Court is seen to be considering political reasons as justifying the presumption of conformity of international and domestic law even in the absence of clear legislative intent (Houle, 2003, p. 9; Rubins, 2004, p. 379).

Scholars have also drawn attention to the role of the Court in transforming domestic law as a by-product of the Court's interpretation of international law, particularly as result of its deference to international commercial arbitration and the reverberations on domestic arbitration (Watson Hamilton, 2003). Party autonomy, which is corollary to the legal principle of privity of contract, represents a legal principle designed to “level the playing field” formally among disputing parties with different socio-political traits. The parties are supposed to be of “relatively equal bargaining strength” and “want to be free of national procedural and substantive law” (Watson Hamilton, 2003, p. 1). This intent, however, is lost in the context of a globalized world economy in which new and powerful non-State actors (NSAs) participate in the process of intergovernmental

rule making (i.e. treaty negotiations)³⁷ and have been advocating a body of rules “free from the idiosyncratic differences that arise between national legal systems” (Watson Hamilton, 2003, p. 3). Promoters of such “liberation” (mainly from the business sector) have advanced contractual theory as a means to secure the independence of the arbitrator’s authority in conducting international commercial arbitration as well as choosing the law governing the contract. In practice, however, the irreconcilability of the legal principle of party autonomy with the principle of judicial scrutiny (court procedure) may entail situations in which party autonomy (of economically unequal parties) will conflict with the imperative of fairness.³⁸

Jurisdictional theory, which challenges contractual theory, represents the opposite extreme on the spectrum of argumentation. It recognizes the State’s primacy as the actor governing the arbitral procedure incorporated in treaties. “The real authority of arbitration derives not from the contract between the parties, but from the recognition accorded by the state” upon which the enforcement of arbitration awards depends (Watson Hamilton, 2003, p. 5).³⁹ The enforcement itself, or the extent of enforcement, is subject to the state’s interest in the fairness and uniformity of law and order (Watson Hamilton, 2003). Sensitive to this dissonance, promoters of international ADR have been increasingly equating an arbitrator’s to a judge’s status, amongst others, by considering for settlement via arbitration issues previously considered as not being subject to arbitration (Watson Hamilton, 2003).

The compromise struck by the Uniform Law Conference of Canada of 1990 in the Uniform Arbitration Act represents a

³⁷ On this issue, see for example, Angela Banks (2003): “Not only are non-state actors instrumental in generating soft law, but they can also be influential in accelerating the political process to motivate states to create hard law, ... through lobbying efforts, informational campaigns, and coordinating action among various organizations and segments of society” (Banks, 2003, p. 295).

³⁸ See also Gal-Or (2004, 2005).

³⁹ Jurisdictional theory is concerned more with the status of the subject of international law and less, if at all, with privity of contract.

mix of contractual and jurisdictional theories,⁴⁰ suggesting a degree of (belated) alignment of Canadian courts' with United States' courts' deferential attitude towards arbitration (Watson Hamilton, 2003). Interestingly, statutory reform in New Zealand and the United Kingdom have circumscribed the reach of contractual theory where a contract was dictated by a more powerful party (Watson Hamilton, 2003, p. 55).⁴¹ These precedents may create reverberations throughout the international trade and commercial legal regime, both with regard to State-to-State disputes involving states of unequal economic power, as well as Chapter 11 type State-to-private party disagreements.

In conclusion, the NAFTA Free Trade Commission and the legal profession have been sensitive to the need for further fine-tuning. The Commission has felt uneasiness with regard to the absence of privity of contract and the fact that, as investors were not party to the treaty, the parties' federal governments were torn between irreconcilable commitments at the international versus national levels. Other issues of concern have emerged from the definitional shortcomings of Chapter 11, for instance, when shareholders were considered as being investors; fault with an arbitral tribunal's scope of jurisdiction where arbitrators applied excessively generous interpretations of the substantive rights provided under NAFTA; problems with the reconciliation of arbitral law with international law, particularly in cases in which, according to NAFTA, a party to a dispute that had unsuccessfully applied a treaty remedy was blocked from having recourse to domestic remedies "even though the full exhaustion of remedies (without order of priority) is a

⁴⁰ The three relevant conflicting principles are: fairness or equality of treatment (reflecting jurisdictional theory); and control by the parties and efficiency (both reflecting contractual theory) (Watson Hamilton, 2003, p. 8).

⁴¹ The fact that investors can avail themselves of Chapter 11 only by accepting it "as is" is an example of a contract dictated by a powerful party (the State). Critics would probably argue that the State negotiated and drafted the agreement under the influence of investors (transnational corporations) and therefore is not more powerful than the investor.

principle of international law (Cowpler, 2002).⁴² Finally, governments have come to realize the high financial costs of arbitrating Chapter 11 disputes (particularly when appealing the tribunal award in a party's domestic court) and consequently undertook to reduce the number of claims. This is, however, a double-edged sword because it may either encourage improvements to Chapter 11 ADR mechanisms or, alternatively, lead to a reluctance to challenge NAFTA arbitral awards.

6. The institutionalization of the NAFTA investor-state ADR mechanism through the FTAA

The previous section discussed the impact of the NAFTA investor-State ADR mechanism on public international law. It pointed out the two innovations in investment law ADR – the expansion of the definition of subjects of international law, and the problem of reconciling the ADR requirement of privity of contract with a treaty framework that enfranchises non-parties. It showed that NAFTA provisions have been a major force in popularizing these innovations, its model being embraced in many BITs as well as bilateral (and even some regional) FTAs. The article now turns to a discussion of the incorporation of the NAFTA investor-State ADR mechanism in the draft FTAA. It is argued that if this treaty is signed and ratified, it will represent the completion of an institutionalization process of new norms in international law, a process reflected in NAFTA, that in turn became a catalyst for its further development.

At the occasion of NAFTA's 10th anniversary celebration, the three member countries' trade ministers declared: "The FTAA will build on the existing free trade agreements and on expanding the links that the NAFTA countries have elsewhere in the hemisphere, allowing them to take full advantage of

⁴² Geoff Cowpler acted as counsel for the Metalclad Corporation in *Metalclad*. Note that the ADR mechanism writ large provides for a succession of what has lately been referred to as "amicable dispute resolution" (excluding arbitration, ADR Rules 4 (ICC, 2001)) whereby consultation and negotiations are in most cases prerequisites to arbitration. Some BITs require the prior exhaustion of recourse to local courts (SICE, 2001, p. 18).

emerging hemispheric markets” (Government of the United States, 2003a, p. 6). Indeed, a cursory review suffices to show that the FTAA dispute resolution provisions have been drafted based upon both the WTO and NAFTA models. Some criticisms of NAFTA’s Chapter 11 have been addressed by the FTAA drafters, who have refined several relevant terms. These concerns were raised, among others, in the Canadian multistakeholder consultations, where participants expressed doubts concerning selected NAFTA Chapter 11 provisions. For instance, participants were troubled by the fact that Chapter 11 includes everything unless excluded, and favours a bottom-up approach; that no investor obligations are attached to the already granted rights; and the fact that individuals who do not fall within the investor definition, are, in this agreement, legally inferior to investors. The discussion on the dispute settlement mechanism weighed the right of direct corporate access to arbitration against access administered through government representation (i.e. contract theory vs. jurisdictional theory) and considered the issues of transparency and voice through *amicus* briefs. The composition of tribunals and the choice of panellists were also discussed (Government of Canada, 2003a). The analysis begins with a review of the provisions of the draft FTAA Investment Chapter that incorporate these (and other) criticisms, and then juxtaposes them with those provisions that remain unchanged.⁴³

Chapter 17 Section C Procedures and Institutions is an overall statement (re-iterated throughout the Chapter) designed to secure business interests and simultaneously reassure civil society. For instance, several articles address civil society’s relentless demand for transparency. Section C.1. Article 21. Transparency provides:

⁴³ The FTAA refinement of investor-State ADR provisions coincides with recent steps undertaken in the United States to reconcile social justice issues with trade and investment relations. For instance, the United States-Jordan FTA represents the first FTA to which the United States is a Party that incorporates labour and environmental provisions within its main text and, in addition, provides a single dispute resolution mechanism for both commercial and social issues (Hornbeck, 2003).

... 21.1. Each Party shall ensure that its laws, regulations, administrative practices and procedures of general application, and adjudicatory decisions, that affect or pertain to covered investments or investors are *promptly published or otherwise made publicly available*. Where a Party establishes policies that affect or pertain to covered investments or investors, which are not expressed in laws or regulations or by other means listed in this paragraph, that Party shall promptly publish them or otherwise make them publicly available⁴⁴ (FTAA, 2003, p. 29, emphasis added).

Non-bracketed Section C.2.b. Dispute Settlement between a Party and an Investor of Another Party Article 30 Transparency of Arbitral Proceedings states that:

30.2. The tribunal shall conduct hearings *open* to the public and shall determine, in consultation with the disputing parties, the appropriate logistical arrangements. *However*, any disputing party that intends to use information designated as *protected information* in a hearing shall so advise the tribunal. The tribunal shall make appropriate arrangements to protect the information from disclosure.

30.3. Nothing in this Section requires a respondent to disclose protected information or to furnish or allow access to information that it may withhold in accordance with Article XX (Essential Security) or Article XX (Disclosure of Information) of Chapter XX (Exceptions) (FTAA, 2003, pp. 53-54, emphasis added).

Transparency in arbitration hearings is addressed in Subsection C.2b. Article 50. Public Access to Hearings and Documents, which reads: “50.1. Hearings held under this Section shall be open to the public” (FTAA, 2003, p. 48). Some degree of standing for the affected non-Party is provided in Article 51 Non-Party Participation stipulating that:

⁴⁴ Brackets represent pending negotiations regarding both content and language and may also reflect complete rejection of the text by one or more negotiating parties.

51.1. A Tribunal may grant *leave to a non-Party* petitioner to file a written submission. In making this decision, the Tribunal shall consider, *inter alia*, whether:

- a) there is a *public interest* in the arbitration;
- b) the petitioner has a substantial interest in the arbitration ...; and
- c) the *non-Party's submission would assist the Tribunal* in the determination of a factual or legal issue related to the arbitration by bringing a perspective, particular knowledge or insight that is different from that of the disputing parties (FTAA, 2003, p. 48, emphasis added).

Progress has been made with regard to the issues of public goods, sovereignty and sub-level government jurisdiction. Subsection C.2. Dispute Settlement Article 22. Dispute Settlement reads:

22.2. Disputes that arise as a result of direct or indirect *governmental administrative decisions of a regulatory or enforcement nature shall not be subject to the dispute settlement provisions of this Agreement*, provided that such decisions are consistent with the legislation of the respective Party and with Articles 4 (National Treatment) and 5 (Most-Favored-Nation Treatment) (FTAA, 2003, p. 29, emphasis added).

Securing the competence, impartiality, and independence of arbitrators are issues addressed in Subsection C.2.b. Article 32. Arbitrators requiring that:

32.2. Arbitrators shall:

- a) have expertise or experience in law, international trade, other matters covered by this Section, or the resolution of disputes arising under international trade agreements;
- b) be independent of, and not be affiliated with or take instructions from, any Party or disputing party; and
- c) comply with the Code of Conduct for Dispute Settlement procedures (Annex XX of Chapter XX (Dispute Settlement))⁴⁵ (FTAA, 2003, p. 38).

⁴⁵ Details on Annex XX were not available at the time of writing of this article.

Based on the above, promoters of a social-justice and public-good⁴⁶ oriented FTAA may see the outcome so far as giving reason for optimism. The shift effected by way of “amending the NAFTA in the FTAA” may suggest that consultations (and civil society’s public protest) have born positive results. Also, while this may signal willingness on behalf of the drafters to respond to trade-and-investment *related* concerns, the modifications remain incomplete. The core problem identified above in the development of international trade and investment law and related dispute settlement – namely the expansion of the definition of subject of international law and arbitration without privity – have yet to be acknowledged. The NAFTA “*status quo*” is overshadowing the corrective FTAA drafting accomplishments as several major concerns have not yet been addressed. They include, for instance, the direct access of an investor to the dispute resolution process to the exclusion of any other private or public (sub-government level) party. Section A General Aspects Article 1 Definitions states that: “disputing investor means an investor who makes a claim under [Subsection C.2.b. (Dispute Settlement between a Party and an Investor of Another Party) of this Chapter:]” (FTAA Draft 3 p. 8) and “[disputing party means [either the claimant or the respondent] [the disputing investor and the disputing Party] (FTAA, 2003, p. 8).

Having adopted the NAFTA innovation of extending the definition of the subjects of international law, Chapter 17 of the FTAA does not move towards a further (equalization) expansion

⁴⁶ Including equality: concerns regarding the development gap between rich and poor member States, and the development constraints experienced by the smaller (poorer) economies, have been accommodated in Section C.2. Dispute Settlement Article 22.3. “Smaller economies shall be allowed access to technical assistance and an extended time period, where necessary, for dealing with state-to-state and investor-state disputes” (FTAA, 2003, p. 29). Subsection C.2.b. Dispute Settlement between a Party and an Investor of Another Party 24. 2. Investor-state Disputes provides that “... [w]here an *investor of a large or developed economy* is involved in a dispute with a *smaller economy State* and the matter is submitted to arbitration, at least half of the legal costs incurred by the State should be borne out of a Regional Integration Fund (FTAA, 2003, p. 30, emphasis added).

of the definition to include other private (or public) actors in addition to the investor.⁴⁷ In fact, the drafters distinguish between trade and commerce, i.e. the public and private economic spheres as they draw attention (in another dispute resolution chapter) to the settlement of private-to-private disputes, which are considered no less important to the promotion of free trade than settlement of investor-State and State-to-State disputes.⁴⁸ They recommend assisting private parties in settling their disputes through mechanisms similar to those governing State-to-State disputes. Article 47 Alternative Dispute Resolution between Private Parties in Chapter 23 encourages the parties as follows:

47.1. Each Party shall, to the maximum extent possible, encourage and facilitate the use of arbitration and other means of alternative dispute resolution for the settlement of international commercial disputes *between private parties*.

47.2. To this end, *each Party shall provide for appropriate procedures to ensure observance of [international arbitration conventions] [agreements to arbitrate] [that have been ratified] and the recognition and enforcement of arbitral awards granted in those disputes. [A Party shall be deemed to be in compliance with this paragraph if it is party to [and is in compliance with] [the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards] [or the 1975 Inter-American Convention on International Commercial Arbitration].]*

47.3. The Parties *may establish an Advisory Committee on Private Commercial Disputes*, comprising persons with expertise or experience in the resolution of international private commercial disputes. The Committee shall present reports and recommendations of a general nature respecting the availability, use and effectiveness of arbitration and other procedures for the

⁴⁷ See Gal-Or (1998a, 1998b, 2002, 2004) and de Mestral (2005) regarding amendments to NAFTA's Chapter 11 investor-state provisions.

⁴⁸ See Dispute Settlement Chapter 23, which deals only with State-to-State disputes.

resolution of these disputes in the FTAA. (FTAA, 2003, Chapter 23, emphasis added).

The emphasis on commercial (not trade) relations was reiterated at the January 2004 Monterrey Special Summit of the Americas, when the leaders of the Americas addressed the disparity between large corporations versus small and medium-sized enterprises (SMEs). They endorsed the granting of financial assistance to SMEs (Government of the United States, 2004b) and the development of various regulations in support of SMEs. For instance, in a move towards promoting a business friendly environment, the United States suggested to strengthen and enforce individual property rights at the national level.⁴⁹ It called on the American States to establish effective property rights systems and proposed to facilitate remittances to Latin America by streamlining transactions costs (Official Agenda, 2004, p. 4). Also, in a bid to encourage job creation in Latin America, the United States suggested to remove roadblocks to starting new business, including impediments to good governance, by declaring anti-corruption as a top target because “[o]nly 25 percent to Latinbarometro’s 2002 survey] expressed confidence in their government or judiciary, the lowest level in six years” (Government of the United States, 2004a, p. 5, emphasis added). The United States proposal did not include suggestions for the setting up of institutional means to overcoming barriers to justice. It is also regrettable that the leaders at Monterrey did not address the possibility of developing additional (less expensive) ADR mechanisms designed to facilitate access by SMEs.

The NAFTA *status quo* is reflected in the FTAA also regarding the issue of “privity of contract”. The formula of “arbitration without privity” reminds of the small letters section within standard contracts, a practice that has been source of discontent in debates on the common law of contracts. Similar to the NAFTA provisions, the investor is invited to accept or reject the FTAA ADR formula. However, rejection of the only

⁴⁹ See Petersmann (2001) regarding international individual property rights, in the section on innovations introduced in Chapter 11.

available procedure shuts the door on any truly negotiated option.⁵⁰ The sole alternative to “arbitration without privity” is recourse to the parties’ national courts, the distrust of which has led to the adoption of ADR in the first place. Loyal to the NAFTA *status quo*, FTAA Chapter 17 (Subsection C.2.b Dispute Settlement between a Party and an Investor of Another Party, Article 30. Conditions Precedent to Submission of a Claim* [*sic* to Arbitration]) stipulates:

30.1. A disputing investor may submit a claim [on its own behalf] to arbitration [under this Section] [under Article 26.1 and 26.2 (Claim by an Investor of a Party on Its Own Behalf or on Behalf of an Enterprise) only if: a) the *investor consents* to arbitration *in accordance with the procedures* set out in [this Section] [this Agreement] (FTAA, 2003, p. 35, emphasis added).

The article continues:

b) ... Accordingly, once the investor or the enterprise has submitted its claim to an arbitration procedure under this Section, *the choice of such a procedure shall be final, precluding the possibility of submitting the claim to the competent national court* of the disputing Party or to other dispute settlement procedures, without prejudice to the exceptions set out above with respect to preventive measures and administrative remedies.... (FTAA, 2003, p. 35, emphasis added).

and Article 30.2 repeats:

30.2. A disputing investor may submit a claim [, on behalf of an enterprise] [under this Section,] [under Article 26.3, 26.4, 26.5 and 26.6 (Claim by an Investor of a Party on Its Own Behalf or on Behalf of an Enterprise)] to arbitration *only if both the investor and the enterprise:*

a) *consent* to arbitration in accordance with the procedures set out [in this Section] [in this Agreement; and

b) *wave their right* to initiate[or continue] any proceedings [before a competent national court under the

⁵⁰ The legal ramifications (consistency in the law) of applying ADR in a manner contradictory to ADR’s own teleology was discussed in the previous section.

law of the disputing Party, or other dispute settlement procedures with respect to the measure of the disputing Party that is alleged to be a breach of the provisions of Article 26.1 and 26.2 ...Accordingly, once the investor or the enterprise has submitted its claim to an arbitration procedure under this Section, *the choice* of such a procedure shall be final, precluding the possibility of submitting the claim to the competent national court of the disputing Party or to other dispute settlement procedures, without prejudice to the exceptions set out above with respect to preventive measures and administrative remedies.) (FTAA, 2003, p. 35, emphasis added).

Arbitration without privity is reinforced in Subsection C.2.b. Dispute Settlement between a Party and an Investor of Another Party Article 31. Consent to Arbitration where the stipulation reads: “31.1. Each Party consents to the submission of a claim ... to arbitration in accordance with the procedures [and requirements] set out [in this Chapter] [in this Agreement] [in this Section]” (FTAA, 2003, p. 36).

7. Conclusion

This article has highlighted two developments in international public law that are flowing from the blurring of the boundaries between private international commercial law and public international trade law. Resulting in the adoption of private law ADR mechanisms within public international law, two legal principles have been affected. One principle provides that only the State is a subject of international law with right of standing in disputes arising under intergovernmental accords. The other reflects the rationale underlying ADR, namely that to be fair ADR must apply exclusively where the terms of the dispute resolution mechanism are adopted by mutual and free consent. NAFTA Chapter 11 challenges both these principles; many BITs have adopted the NAFTA model; and it is possible that the FTAA could follow suit. Consequently, NAFTA Chapter 11 would emerge as a path-breaking development with revolutionary implications. This is a matter of great concern

because these changes to the above mentioned doctrines and traditions are being institutionalized without paying attention to the ensuing inconsistencies created within international law.

While the incorporation of ADR within international trade law is salutary, such a development must be conditioned on a thorough, consistent and teleological assessment of the implications for international law. This calls for (a) a head-on debate of the re-definition of the subjects of international law, and (b) an examination of the rationale underlying the extended (private-public) version of the ADR option in international law. While NAFTA critics have contributed to a comparatively “kinder” draft FTAA, the core issues raised by NAFTA in these respects have not yet been addressed. In these debates, it is advisable to be mindful of the economic, political, social, and cultural characteristics of the North American as well as Latin American regions. Although comparisons of NAFTA with the EU abound,⁵¹ trade and investment are still perceived differently on both sides of the Atlantic. The creation of such institutions as the European Court of First Instance or the ECJ⁵² may be inappropriate for NAFTA or the FTAA, but this should not

⁵¹ Former United States Trade Representative Robert Zoellick recognized that “[t]he extent of the New World’s new influence will depend on the pace and scope of the economic synthesis, *similar* to the way Europe’s Union worked to combine visions with realities over time” (Government of the United States, 2003b, emphasis added).

⁵² To be sure, the FTAA consultations have evidenced increasing caution regarding concern over a possible democratic deficit and attention to the EU’s influence. In addressing the Americas’ (both hemispheres) commitment to the Inter-American Democratic Charter and its relation to the FTAA, it was noted that: “[a]greements between countries in the Americas and the European Union (EU) and its Member States offer other examples of the application of ‘democracy clauses’ to trade and democratic agreements. ... Since then EU practice has evolved, and clauses establishing respect for human rights and democratic principles as an ‘essential’ element of the treaty relationship are standard in EU trade and economic agreements. Such a clause is found in the EU’s agreements with Mexico, Chile and MERCOSUR, and in the Cotonou Agreement to which many Caribbean countries are party There will be many challenges in developing an appropriate way to give effect to the relationship between the FTAA and the Charter” (Government of Canada, 2003c, pp. 3-4).

overshadow other possibilities for improving access to justice. For instance, FTAA drafters might consider setting up FTAA administrative tribunals and small claims courts open to any citizen of the contracting parties (Gal-Or, 2002e). As the issue of justice becomes increasingly regulated within the framework of both NAFTA and the FTAA, an overhauling of the ADR mechanisms to bridge the divide between trade and commerce, i.e. between public and private international law, is imperative. The evolution of trade and investment law must go beyond the resurrection and revision of *lex mercatoria* traditions and respond to 21st century socio-economic realities and needs with imagination. ■

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REVIEW ARTICLE

More – yet more – on globalization

John H. Dunning*

In Defence of Globalization

Jagdish Bhagwati

(New York, Oxford University Press, 2004), xi + 308 pages

Why Globalisation Works

Martin Wolf

(New Haven, CT and London, Yale University Press, 2004), xviii
+398 pages

Globalisation and Its Discontents

Joseph Stiglitz

(London, Allen Lane, 2002), xvi + 212 pages

Books on globalization continue to abound. As one who wrote one of the earliest volumes on the subject in 1993,¹ I am continually amazed at the ingenuity of scholars, journalists, politicians and business executives to rediscover and recite the actual and perceived costs and benefits of the growing cross-border inter-connectivity of economic activity, and to do so in so many different ways. Surely, I thought, as I came to read the three books under review, nothing more of value could possibly be said.

I was wrong. I should have known better. I should have appreciated that three economists and commentators with such impeccable credentials as Joseph Stiglitz, Jagdish Bhagwati and

* John H. Dunning is Emeritus Foundation Professor of Economics and Esmee Fairbairn Professor of International Business, University of Reading, United Kingdom and Emeritus State of New Jersey Professor of International Business, Rutgers University, United States.

The views expressed in this review article are those of the author and do not necessarily reflect the views of the United Nations.

¹ *The Globalisation of Business* (London, Routledge, 1993).

Martin Wolf would not only have something original to say, but also they would do so in a carefully crafted, yet reader-friendly way. Each volume deserves its place on the bookshelves of all those interested in this highly topical, fascinating and challenging topic.

The current round of globalization – as the authors remind us, earlier rounds took place in the late nineteenth and early twentieth centuries and in the late 1950s and 1960s – can be traced back to the fall of the Berlin Wall in 1989; to the renaissance of market economies, spearheaded by Margaret Thatcher in the United Kingdom and Ronald Reagan in the United States; and also to the emergence of a new wave of technological advances that culminated in the global embrace of E-commerce in the late 1990s. *Inter alia*, it has been fashioned by a widening and deepening of all forms of international business activity, especially of foreign direct investment (FDI), a dramatic reduction of cross-border transport and communication costs, and ever closer awareness linkages, by way of people's movement, radio, TV and the printed word. As a result, for good (or bad), what, 60 years ago, were a collection of economically protected, politically independent and culturally distinctive nation States are now, for the most part, better regarded as inter-related parts of a global village.

Of course, there are exceptions to this general statement. Economic globalization is not all inclusive, and some countries have embraced its characteristics more than others. As currently illustrated by the debate on the future of the European Union (EU), national sovereignty and cultural freedom still remain valued assets. Moreover, as Alan Rugman has pointed out in several of his recent writings,² in some respects, regionalization describes the current status of the geography of transnational business activity better than does globalization.

Nevertheless, the expression “globalization” – though it may mean different things to different people – is now part and

² See, for example, Rugman and Verbeke (2004).

parcel of our everyday language, and 25 or so years since its inception in modern guise is a long enough period for us to make a reasoned appraisal of its evolving content, determinants and effects.

This is exactly the purpose of these three volumes, although, as might be expected, each author takes a somewhat different approach to his topic. At the same time, each is trying to lay to rest some of the more popular myths about globalization. Each, too, attempts to assess the costs and benefits of economic inter-connectivity from the viewpoint of various interest groups, and of what might be done to increase its net benefits and to resolve such conflicts as and when they arise. Each is also writing for a general audience and, I believe, is seeking to give the reader both a sense of the complexity of the causes and consequences of globalization, and of the need to assess these in terms of other options of organizing the world's wealth creating activities. Finally, rather than addressing the question "Is globalization a good or bad thing?", Bhagwati, Wolf and Stiglitz have each preferred to identify ways and means of making its existing content and effects economically more productive, socially more acceptable, morally more sustainable, and geographically more inclusive.

Of the three volumes, those by Bhagwati and Wolf are the more similar, both in their subject matter and in their judgement about the rationale for, and consequences of, globalization. Each is fully convinced of its net benefits – Wolf, perhaps, more so than Bhagwati. The latter, in a section of his volume entitled *Globalization's Human Face: Trade and Corporations*, gives more attention to social and cultural issues, including those that have to do with poverty and the interests of women. Wolf's emphasis as, perhaps, befits the Chief Economic Commentator of the *Financial Times* is more directed to the implications of globalization for capitalism in general and the operation of transnational corporations (TNCs) in particular. His assertion that there is "too little" globalization rests on the proposition that it is primarily the misguided policies of national governments and the ineffectiveness of international institutions

that are inhibiting the benefits of international trade and FDI to be spread more widely. However, he, too, is aware that the tools of globalization may be used to promote “bad ends”, and, in this respect, has some pertinent remarks to make about how certain threats to economic prosperity, e.g. those arising from international terrorism and drug trafficking, may best be countered.

Both Bhagwati and Wolf deal cogently and persuasively with some common misconceptions about the effects of globalization on trade, jobs, income distribution, entrepreneurship, knowledge creation and dispersion, and the environment. Both present counter arguments and illustrations to those advanced by the anti-globalization movement. While Bhagwati cites econometric studies as supporting some of the beneficial consequences of globalization, for the most part, both authors rely on casual empiricism to support their arguments. This, more than anything, reflects the paucity of the data on the effects of globalization. However, as is most clearly illustrated in the debate over income distribution, much depends on the definition of the terms used, on exactly what one is trying to measure, and where prices are involved, on which exchange rate one is using to make cross border comparisons.

Subject to these caveats, both Bhagwati and Wolf present their subject matter in an attractive and reasoned way. Perhaps, understandably, both tend to generalize their findings, although both – and especially Bhagwati – do recognize that, when viewed contextually and in the short run at least, there may be losers in the *process* of globalization. Particularly, this is likely to be so when it is driven by technological change. The loss of jobs of those employed at call centres in the United Kingdom and the United States as a result of new technology enabling such activities to be more economically undertaken in India is a case in point.³ Bhagwati pays more attention to the responsibilities of national governments and to the institutional architecture undergirding globalization if it is, in his words, “to be made

³ For a detailed examination of this issue see UNCTAD (2004).

better” than does Wolf. But this may be a matter of emphasis, rather than a different perspective, of the two economists. Certainly, my own predilections follow more closely those of Bhagwati. I firmly believe that globalization (or indeed regionalization) should not reduce the role of national governments. Rather, I consider that governments should realign the incentive structures and enforcement mechanisms over which they have control or influence so as to ensure that the wealth creating organizations within their jurisdiction can fully exploit and capture the benefits of globalization, while satisfying the localized needs and aspirations of their constituents.

I would further argue that this last challenge is particularly relevant to the impact of globalization on the poorest developing countries, especially those in sub-Saharan Africa. Neither Bhagwati nor Wolf gives as much attention to this issue as I would have liked. How does globalization affect the economic and moral responsibility of the rich to the poverty stricken countries? How does it change the balance between aid, loans, trade, foreign portfolio and direct investment? Is there a need for a more holistic approach to the reconfiguration of the institutions and incentive structures both in developed and developing countries to “making poverty history”? Does globalization not lay bare the need for more partnerships between its main stakeholders – firms, investors, consumers, civil society, national governments, supranational entities – to further a whole range of development goals? Here, I believe the thinking and recommendations of Armatya Sen in his book *Development as Freedom*,⁴ and of Stiglitz in a chapter in my own edited volume *Making Globalisation Good*⁵ are especially relevant. To be fair, however, Bhagwati, in particular, is well aware of the inappropriateness and/or inadequacies of the wealth facilitating institutional structure and implementing organizations in the poorer developing countries. I only wish that, in the final section of his book on governance, he would have identified some of the changes required of these as a result of the impact made by

⁴ Published by Oxford University Press, 1999.

⁵ Oxford University Press, 2003 (paperback edition, 2004).

globalization on the human environment, including traditional cultures, ideologies and norms of doing things.

What of the actual or perceived downsides of globalization? Clearly, both Bhagwati and Wolf, while acknowledging there are downsides, believe that these are primarily contextual and not systemic. However, both authors recognize that extra-market organizations need to work together with the main wealth producing entities to ensure that the inevitable uncertainties, volatilities, shifting distributions of economic power, and challenges to sovereignty posed by it, are best reconciled. Neither authors underestimate the magnitude of this task. Both, too, accept that achieving it, in a world made up of individuals and organizations from different cultures and mindsets demands a consensus of beliefs, not only about the objectives of globalization, but also on the content and form of national and supranational incentive structures, and of how the main wealth creating organizations set, or respond to, these goals and institutions.

Both Bhagwati and Wolf present their own agenda for making globalization better. In the final chapter of his volume, Wolf sets out a ten-point plan, directed primarily to governments and supranational entities. By and large, he recommends a more focused, more efficient, more integrated approach to maximizing the benefits of the closely inter-connected global economic environment of the early twenty-first century. Although, elsewhere in the volume, he has something to say about the role that corporations, investors, consumers and workers may play in this task, such a “bottom-up” approach does not appear to be top of his agenda.

Bhagwati also mainly addresses his recommendations to governments and supranational agencies, though he recognizes that a “shared success” in a more efficient and fairer globalization requires the inputs from both firms (and particularly TNCs) and a whole cadre of NGOs. But unlike Wolf, he pays more attention to the need for institutional upgrading and restructuring both at the national and supranational levels;

to issues of poverty, trade liberalization and adjustment mechanisms; and to advancing a medley of social goals.

Between them, the Bhagwati and Wolf volumes cover all the major issues raised in the globalization debate. I liked both books a great deal, even though I wished that more emphasis had been given to policy issues influencing the role of TNCs, both in shaping the kind of economic connections now spearheading the globalization process, and in determining the form, extent and spatial distribution of the net benefits arising from their activities.

While the Bhagwati and Wolf monographs touch upon the role of supranational entities as they have so far influenced the process of globalization, and on what might be done to make this role more economically effective and socially acceptable, it is Stiglitz who devotes most of his attention to this issue. Of the three authors, he is the most sympathetic to those who are sceptical about the benefits of globalization. In particular, he questions the extent to which the proponents of free market liberalization, such as those supporting the Washington Consensus, have delivered their promises of increased economic well-being to such transition economies as Russia. At the same time, Stiglitz observes that those countries that have most fully exploited the opportunities offered by globalization, notably China, have done so *without* much help from such organizations as the International Monetary Fund and the World Bank. The Republic of Korea's recovery from its economic crisis since the mid 1990s was also largely domestically orchestrated. How was this possible? According to Stiglitz, it was because they strengthened and restructured their domestic institutional architecture in a way that helped both their indigenous firms and the foreign affiliates in their midst to become more important players in the global economy.

In writing his volume, Stiglitz had the benefit of both excellent scholarly credentials (he was the joint winner of the Nobel Prize in Economics in 1991) and unrivalled experience as a consultant and adviser to a large number of developing and transition economies. The message of his volume – and one that

he preached while he was Chief Economic Adviser to the World Bank – is that, to benefit fully from all the advantages of economic interdependence and the complexity of today’s human environment, there must be a drastic change in the mindsets and institutional mores of the main supranational designers of globalization. At the same time, a restructuring of institutions in developing countries, particularly in respect of property rights, banking regulations, the legal framework and a whole range of enforcement mechanisms is required.

Stiglitz has comparatively little to say about the role of TNCs in the development process, but even here (on pp. 68/70) he is more concerned than either Bhagwati or Wolf about their possible adverse affects, e.g. with respect to crowding out local competitors, engaging in monopoly pricing and insufficiently using their ownership advantages to improve local working conditions. He also has a good deal of advice to offer host developing countries about upgrading their domestic institutions and sequencing their strategies and policies towards market reform and industrial restructuring. He strongly believes in encouraging local entrepreneurship, the ownership (or part ownership) of key resources and capabilities for development, and multi-stakeholder involvement in the decision-making process. In short, Stiglitz, while learning from experiences of developed countries, wants developing countries to evolve their own brand of global economic involvement, and to create or redesign their own institutions to further this objective.

But Stiglitz’s main contribution to the globalization debate rests in his trenchant criticisms of the leading supranational agencies in advancing the economic and social goals of many developing countries. Perhaps, the main butts of the criticism are directed to first (as he sees it) the “one-size-fits-all” philosophy of the Fund and the Bank, and second to the lack of appreciation of these organizations that, to promote efficient and socially acceptable markets, a sound legal, commercial, social and moral architecture – suitable to the particular cultural heritage and belief systems of the countries and regions in question – needs to be in place.

Chapter headings “Broken promises”, “The East Asia crisis”, “How IMF policies brought the World to the verge of global meltdown?”, “Who lost Russia”, “Unfair trade laws and other mischief”, “Better roads to the market” give a glimpse to the main thrust of Stiglitz’s discontent with the present state of globalization. In a nutshell, the main charge he levels at the trio of supranational agencies (the Fund, the Bank, World Trade Organization) is that, in one way or another, they have failed to restructure their institutions and policies from those designed 60 years ago to avoid a repeat of the self-inflicted wounds arising from the economic protectionism of the inter-war years to those more appropriate to the opportunities and challenges of globalization of the twenty-first century.

Each of Stiglitz’s recommendations for reform, set out in chapter nine, is designed to promote this objective. Sometimes, these are directed to changing the governance and voting rights of the international organizations; sometimes to reconfiguring the focus of their activities; sometimes to meeting the need for new organizations, e.g. to reach for a (realistic) global consensus on such issues as the environment, climate change, health and poverty alleviation; sometimes to streamlining administrative procedures; sometimes to understanding better the importance of partnership and a division of ownership of resources, capabilities and institutions between supranational agencies and domestic organizations in individual countries; sometimes to reconsidering the principles and terms of conditionality attached to aid or loans; sometimes to tackling the question of debt and carbon emissions;⁶ sometimes to appreciating the moral and ethical challenges posed by the global spread of capitalism; and perhaps, above all, to promoting better-managed and more flexible institutions that take account of the fact that we live in a dynamic and volatile planet, and one in which there is constant tension between the benefits of international economic integration and the desire of people and national (or regional)

⁶ Now, in the summer of 2005, Governments have taken a major step forward on debt by the decision of the G8 wealthiest countries at their annual meeting at Gleneagles (Scotland).

organizations to retain their individual identities, and freedom to choose their own destinies.

Each of these three books is to be warmly recommended. Between them they identify and evaluate most of the successes and failures of globalization. However, they differ in their attributions of these successes and failures. For example, neither Bhagwati nor Wolf castigates the three supranational entities for their part in the downsides of globalization to the extent that Stiglitz does. But for the readers of *Transnational Corporations*, each volume provides essential material for a better understanding of the conditions under which TNCs may contribute to the economic and social needs and aspirations of the citizens of the countries in which they operate; and also those that both home and host countries need to take into account when reconfiguring their attitudes and policies towards both inward and outward FDI as a means of enhancing their domestic productivity.

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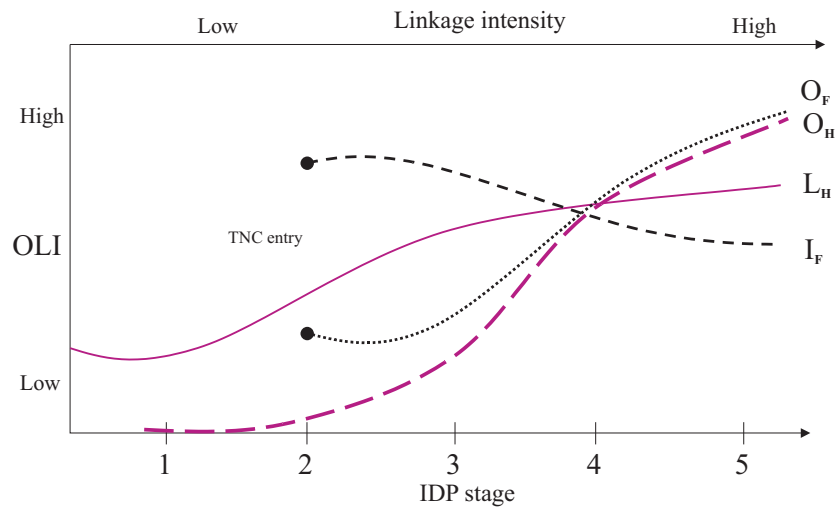
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Corrigendum

In the April 2005 article by Joanna Scott-Kennel and Peter Enderwick on FDI and inter-firm linkages, figure 2 (on page 124) inadvertently did not contain two lines. The correct version of figure 2, which should have 4 lines rather than 2, is as follows:

Figure 2. OLI configuration, linkage intensity and IDP stages



Source: the authors.

BOOK REVIEWS

Foreign Direct Investment: Six Country Case Studies

Yingqi Annie Wei and V.N. Balasubramanyam, editors
(Cheltenham, Edward Elgar, 2004), 218 pages

The vast literature on foreign direct investment (FDI) has been suffering from a lack of comparative work based on specific case studies drawn from different regions of the world. This gap is now being filled with the book under review written by well-known contributors and discussants in the area. The choice of the six countries for case studies •China, India, Malaysia, Mexico, Ireland and sub-Saharan Africa with a specific focus on Nigeria “ is pertinent, for these countries belong to various regional groupings of the world, which, beyond their many differentiating factors, share many common features. In particular, membership to more economically integrated regions of the world (such as the EU, ASEAN, NAFTA) implies the firms are able to use the selected host economies as export platforms within regional groupings. The countries studied in this volume have all moved from import substitution regimes to FDI-led growth and export-oriented regimes.

The inclusion of Africa in the analysis, the forgotten region of the world, is most welcome, and the addition of Ireland is not surprising if one considers the fact that, up until the early 1990s, Ireland was one of the four poorest member states of the EU. The analysis of FDI is presented with due reference to a number of recurrent themes in each of the chapters. These are the determinants, characteristics and impact of FDI in terms of economic growth and economic development. When combined with the discussion on the differentiating features of each country, this common thread allows the reader to explore a number of important questions. One critical issue implied by this comparative work is whether any of the countries under

analysis can be viewed as a role model for other countries in the world.

The chapter on China provides a comprehensive review of the existing literature on the characteristics, determinants and growth impact of FDI. Starting with a brief presentation of the four stages in China's FDI development path, the chapter highlights the importance of the Chinese diaspora (also in Western countries) in the inward FDI phenomenon. It shows how wholly-owned foreign affiliates have increased lately. It reasserts the importance of trade by foreign affiliate (usually referred to as "foreign-invested enterprises" in China) and it points to the uneven regional distribution of FDI. The chapter brings to the fore a number of new and challenging features of FDI in China, in particular, the increasing importance of FDI in the capital and technology intensive industries. The literature on the determinants of FDI in China has built up considerably in the past decade. An interesting finding is that the low labour cost advantage of China is probably a feature of the past, for China will not be able to withstand much longer the labour cost competition from neighbouring countries such as Viet Nam, and also India. The author argues that FDI has certainly benefited the Chinese economy from both a macroeconomic and microeconomic level, although the benefits have been spatially skewed. An interesting comment proffered by the discussant ought certainly to be given more consideration by the Chinese authorities. This is that, in spite of a very high savings rate, domestic entrepreneurs face a finance constraint which allows, in effect, FDI to become a substitute for domestic investment.

The case study of India brings extremely useful and thought provoking elements to the analysis of FDI in general. The problem of the relatively low level of FDI inflows into the country when compared with China since the beginning of the economic reforms in 1991 opens the chapter. From the outset, the authors warn against the mechanistically beneficial impact of FDI, a common and rarely challenged view in the literature. The authors argue, indeed, that "sweeping generalizations such as that FDI brings huge advantages, it has no downside, and

that throwing doors wide open would necessarily attract increased volumes of FDI are suspect” (p. 48). In particular, India’s FDI policy framework has been one of the most liberal investment regimes, and yet the country has not attracted levels of FDI comparable to those of China. Caution must be exercised for, again in the view of the authors, “it is a bit farfetched to argue that FDI is a panacea for the development problem and India should throw all doors open to FDI” (p. 59). Consequently, the authors question whether China is a role model for India in its effort to attract FDI. Their review of the differentiating factors that oppose the two countries shows, for example, that the large Chinese diaspora community often active in business “is found mostly in Asia, whereas the Indian diaspora are mostly in the United States, the United Kingdom and other western countries, and belongs to professions such as education, health services and science. FDI in India has traditionally been found in high-tech industries and in services, whereas it has been in low-tech industries in China. It is the quality of FDI as well as its surrounding environment, rather than its quantity, that determines its impact on economic development. The efficacy of FDI is greater in India compared with China, for India is capable of generating relatively high growth rates with less FDI. Finally, the chapter concludes with some policy implications, such as the necessity to implement policies that are also in the interest of domestic investors.

The chapter on Malaysia is a valuable case study on the difficulties encountered by a fast developing economy that has opted for an FDI-led growth and export-oriented policy since the late 1960s, with a priority given to the development of the electronics industry. The chapter reviews the developmental stages of the country since independence and it provides an insight into the incentive package to attract FDI. It shows indeed how the policies to attract FDI have evolved, in line with the international division of labour and the comparative advantages of competing countries, and with the move towards high value-added and research intensive activities (a pattern which is common to many countries of the world, including Ireland). The problem of weak linkages is mentioned, although rather briefly,

and the authors explain the weakness in terms of backward linkages by the low technological capability of domestic firms, as well as by the lack of investment incentives targeted at specific outcomes – such as local content requirements. Another important problem is the “distortion” that has been created by government policies in the productive structure of Malaysia, with an inappropriate indigenous sector and discrimination in favour of Malay entrepreneurs.

Another case illustrating the shift from import substitution industrializing policies (back in the 1940s) to an open regime (in the 1980s) is represented by Mexico. Making up for approximately 10% of all FDI inflows into the developing countries in the 1980s, FDI in Mexico has been spatially concentrated in the *maquiladoras* (developed during the 1960s), increasing thereby wage inequality and potentially regional disparity in the country. The analysis of the spatial impact of FDI remains, nevertheless, at a very preliminary stage, for the authors prefer to fill a notable gap in the literature on FDI in Mexico by analyzing the determinants of FDI and by analyzing the FDI-growth relationship with the help of econometric modelling. Although the findings of their analyses are subject to great caution (as acknowledged and warned by the authors themselves), the authors find that FDI played a role in Mexican economic growth over two sub-periods (1979-1985 and 1986-1999). These sub-periods correspond to two different trade and investment regimes. The explanation for the increase of FDI over time, in relative terms, by Japanese and EU firms may be, as pointed out by the discussant, because the Mexican *maquiladoras* are increasingly used by these firms as production and export platforms to the United States. This shows the importance of regional integration in the FDI phenomenon.

The chapter on Ireland has the merit of proposing a comprehensive description of industrial policy in a small open Western economy that has succeeded in catching up with the EU average. This chapter portrays a picture of FDI in Ireland over the past four decades, with a specific focus on policy aspects. It shows the evolving industrial policy of the

Government, with its corporate tax rate as the cornerstone since the late 1950s. Although evolving over the years so as to respond to international trends, with, for example, more selectivity and coercion, the policy is characterized by consistency. By focusing on the policy aspects, the chapter examines the role of FDI in Ireland's growth process. After a discussion of policy objectives and approach, it analyzes whether or not the policy objectives have been met and goes on by suggesting an assessment. Given the current problem of sustainability of the Irish developmental model, the chapter then looks at future policy objectives, future policies and at the possible relevance of the Irish model to other countries, notably those in Eastern Europe.

The discussion on the determinants of FDI (in particular, the low corporate tax rate) leads to the conclusion that Ireland has attracted firms precisely in the areas in which it had no comparative advantage. Nevertheless, and in contrast with Malaysia for example, Ireland has been relatively successful in fostering linkages and spillovers, although the strength of the indigenous industries in Ireland is still open to debate. The FDI policies have certainly succeeded in maximizing growth and employment in the country. This invites the author to question whether the future policy goals for promoting FDI should move away from employment and towards more qualitative targets, such as economic welfare, a stronger research base or/and a decreasing dependence of the Irish growth process on foreign firms.

The chapter on FDI in sub-Saharan Africa (SSA) brings a much-needed addition to the literature dealing with the widespread theme of Africa's many "lost decades" since independence and its connection with protectionist trade and investment policies. This chapter provides an excellent review of the main issues connected with FDI in Africa.

The share of the SSA in the world total FDI stock has declined from 9.1% in 1980 to 4.8% in 2002. One notable characteristic of FDI in SSA is its spatial concentration in mineral rich countries such as Angola, Nigeria, South Africa,

representing more than three-quarters of FDI flows to Africa in 2001. Although in terms of GDP or of gross fixed capital formation, the volume of FDI in Africa is on par with that of other developing regions, this volume is, nevertheless, not adequate in terms of stimulating growth and alleviating poverty. The determinants of FDI are classified into *policies towards foreign firms* and *economic and business environment* (including corruption, governance and the financial structure). Since corruption features as the main obstacle to FDI in Africa, the chapter focuses on this issue, by trying to measure its incidence in the case of Nigeria. The author estimates the size of the Nigerian hidden economy using the MIMIC technique (multiple indicators, multiple independent causes). Because of the lack of data, the author is compelled to discard a number of standard causal variables, and the model is reduced to a few variables such as the tax burden, inflation and per capita income, as well as the changes in the cash demand deposit ratio. Again, because of data and methodological limitations, the results need to be interpreted with great caution. The author finds that the size of the hidden economy in Nigeria has increased since the 1970s, and that strikingly, FDI inflows have continued to rise during this period. In the eyes of the author, this is explained by high returns on investment in the oil industry. The further econometric analysis, which could have benefited from further refinements, reveals that FDI promotes growth, whereas corruption retards growth, and that growth enhancing efficiency of FDI is adversely affected by corruption.

The case study approach proposed in this book integrates up-to-date elements pertaining to the study of FDI, and this is certainly extremely useful as it allows the reader to refine the theoretical underpinnings of FDI. It may be said, nevertheless, that the book suffers from the absence of a synthetic chapter pulling together the lessons drawn from the individual case studies. These limitations notwithstanding, the comparative approach in this book is highly commendable, and this work is an essential reading for anyone interested in the comparative aspects of FDI. It brings to the fore the latest developments in the area of FDI in relation to the six selected countries. It offers

interesting challenges to some of the views that permeate the FDI literature, and it should therefore be of considerable benefit to scholars, practitioners and businesses alike.

Bernadette Andreosso-O'Callaghan

Jean Monnet Chair of Economics
University of Limerick
Ireland

Investment Strategies in Emerging Markets

Saul Estrin and Klaus Meyer, editors
(Cheltenham, UK and Northampton, MA, Edward Elgar,
2004), 371 pages

The aims of this book are ambitiously comprehensive – that is, to investigate investment strategies in four emerging markets in relation to the determinants of foreign direct investment (FDI) and its implications for the host economy, business and public policy. Emerging economies pose particular challenges to investors because of weaknesses in their institutional environment and the extent to which informal institutions vary from those in developed market economies. Unusually, therefore, in analyzing the link between the host country environment and investment strategies, the book not only draws upon the corporate strategy literature and addresses the social and corporate outcomes of FDI but also utilizes literature on entry modes and the impact of institutions on strategy.

The authors' starting assumption is that the link between FDI and corporate and social performance depends on the chosen entry strategy. This determines when, how and where inward investment is located and sets the framework for subsequent corporate performance and impact on the host country. The research focuses on two complementary aspects of FDI: first, on how foreign investors adapt their strategies to the specific context of emerging markets, particularly to their imperfect institutional frameworks and weak resource bases; and second, on how and to what extent the host economy can gain from FDI in terms of spillovers for factors like employment, knowledge and technology transfer and diffusion, the impact on local businesses and suppliers, etc.

The research design and the subsequent reporting of the results are highly structured to facilitate navigation through such a complex set of issues. Egypt, India, South Africa and Viet Nam were chosen as the subjects of the study on the grounds

that, despite significant cultural, geographical and economic differences, these emerging markets share common characteristics. In the not so distant past, all four were relatively closed economies with a significant degree of state involvement and all underwent economic liberalization in the 1990s and experienced big increases in FDI inflows from the mid-1990s onwards.

Given the varied research objectives, multiple complementary research methods are utilized. Background papers review the institutional and economic framework for FDI in each country and trends in FDI and entry modes. This analysis is augmented by questionnaires (with a minimum of 150 responses in each country) that establish the basic characteristics of investing firms (such as size, sector, entry modes and strategies); the importance of resources in inward investment; the role of training; the role of the institutional environment and overall assessment of investment performance in the host economy and whether the context in which investment is taking place has improved. More in-depth analysis arises from the inclusion of three case studies from each of the four countries. The case studies and the questionnaire-based surveys have been conducted by researchers from leading local institutions in the emerging countries themselves in accordance with a jointly-developed common framework co-coordinated by a team at the London Business School.

The book's structure reflects the systematic nature of the research and facilitates presentation of its comparative aspects. The first chapter introduces key themes and outlines the scope of the book. Chapter two summarizes and interprets the empirical findings of the research from a comparative perspective. The core findings are presented in the following eight chapters •one pair of chapters for each of the sample countries. The first of each pair of chapters provides an overview of the key contextual issues influencing FDI in that country and a summary of the key findings of the relevant questionnaire. The second chapter in each pair presents the three detailed case studies of foreign investors. The disparate strands of the research findings are

pulled together in the concluding two chapters. The penultimate chapter draws out the inferences and practical implications of the research for managers in transnational corporations (TNCs) and for their local partners whereas the final chapter does a similar job for policy makers at a national level and above.

The results of the research paint a very different picture from the experience of FDI in developed markets. Some findings confirm expectations whereas others confound them. For example, the survey reveals that most FDI to emerging economies is of relatively small scale, both in terms of capital deployed and jobs created, and that a surprisingly high proportion of it is directed towards financial and business services and tourism. The exception is Viet Nam where manufacturing dominates FDI. Moreover, around three quarters of FDI in the sample countries is motivated by market-seeking rather than efficiency-seeking reasons, thereby confounding expectations based on models of comparative advantage that much TNC involvement in developing countries consists of manufacturing outsourcing to take advantage of cheap labour and abundant, low cost natural resources. The market-seeking motivation is particularly true of South Africa and India. However, the latter does contain a small but important efficiency-seeking element in the information technology industry. Efficiency-seeking investment is more prevalent in Viet Nam.

The research aims to identify the relative influences on entry mode choice rather than the effectiveness of alternative entry modes. Indeed, the choice of entry mode in emerging markets is frequently constrained by local conditions and is dominated by greenfield investment and joint ventures which, according to the entry modes literature, generates more modest spillover opportunities than acquisitions, the entry mode of choice in developed countries. The unpopularity of acquisitions in emerging markets is partly explained by the absence of appropriate acquisition targets and the under-development of capital markets. Acquisitions do play a greater role in South Africa due to its greater institutional maturity compared to the

other three sample markets. However, entry modes are not fixed and the research indicates there are significant gains to be made by customizing modes to the local context.

Findings about the business environment and its impact on business strategies confirm the conventional wisdom about FDI in emerging markets. Indeed, for investing firms, their overriding concern is the policy, legal and institutional environment. The questionnaires revealed general dissatisfaction about bureaucracy and corruption: the managers surveyed did not rate the host country institutional and policy environment highly and, with the exception of Viet Nam, reported no improvement in these factors over time. Indeed, the questionnaires suggest that weak institutional environments distorted the choice of entry mode even further away from acquisitions in favour of greenfield and joint venture entry. If this is combined with a preference for market seeking investment, which reduces pressure for international competitiveness, foreign investors will tend to adapt to the existing local environment rather than lobby for institutional and policy reform.

In terms of spillovers, the results suggest that, even in emerging markets with relatively large FDI inflows, policy makers should not regard FDI as a major source of job creation. Rather, the main spillover benefits from FDI come from improvements in competitiveness. This implies that the efforts of policy makers should be directed towards the creation of an institutional and regulatory infrastructure that enables inward investors to take advantage of investment opportunities with limited risk. The sectoral composition of FDI implies that the policy focus should not only be on the industry but also on the spillovers to be obtained from the development of capital markets and business services through inward FDI.

One clear conclusion emerging from the research is that local familiarity, experience with emerging markets and integration into regional trading blocs also play an important role in the FDI process. Many investors in the sample countries

originate from within the region and regional trade and integration policies, as well as global ones, often influence location decisions. The authors, therefore, recommend that policy makers should think more carefully about how to develop their FDI strategies in the context of regional trade policies and development of regional trade groupings.

As this far from exhaustive summary of the book's findings shows, its findings and conclusions are wide-ranging in scope. There is something for everybody with the remotest interest in FDI. For example, I find the conclusions regarding the importance of regional integration in FDI particularly interesting. Entry mode scholars, on the other hand, also have plenty to whet their appetite. Overall, the book is a stimulating read that both confirms and challenges conventional wisdoms and indicates an exciting future research agenda.

Debra Johnson

Hull University Business School
University of Hull
United Kingdom

The Future of Foreign Investment in Southeast Asia

Nick J. Freeman and Frank L. Bartels, editors
(London, RoutledgeCurzon, 2004), 288 pages

In the past two decades, some major trends of foreign direct investment (FDI) in South-East Asian countries have become evident. First, FDI inflows increased rapidly from the mid-1980s to the early 1990s, rising from \$2 billion in 1985 to peak at \$21 billion in 1995. However, after the Asian crisis in 1997-1998, foreign investment into the region declined dramatically. In contrast to the global FDI expansion during the latter half of the 1990s, inflows into South-East Asia collapsed to \$12 billion in 2000. At the same time, China emerged as a major regional competitor for FDI, attracting significant volumes of capital (up from \$15 billion in 1998 to \$62 billion in 2000). On top of this, the beginning of the millennium saw a major downturn in worldwide FDI flows with implications for most host countries, including those in South-East Asia.

This twelve-chapter volume, edited by Frank Bartels and Nick Freeman, attempts to re-examine the much analyzed topic of FDI in South-East Asia in a forward-looking manner. As the title indicates, the main topic that the authors attempt to address is the prospects for foreign investment activities in the region. However, like most writings about the future, the book is also very much about the present. It sets out to understand better the dynamics that lie behind South-East Asia's current foreign investment activity and, based on this, extrapolates likely future scenarios.

In the first chapter, the editors provide an historical profile of world, regional and South-East Asian FDI patterns in a 20-year perspective. While short and concise, the introduction conveys a quite pessimistic sentiment regarding the current situation and outlook for South-East Asian FDI. A main concern is that the region will remain overshadowed by China, especially

if Governments fail to recognize the importance of adapting policies to the changing forms and content of FDI with respect to, for example, the rising numbers of M&As and recent technological developments impacting on the sourcing choice of transnational corporations (TNCs). In the context of increasing competition, regional initiatives to support intra-ASEAN investment flows are put forward as a source of competitive advantage, which is yet to be realized in its full potential.

The subsequent contributions address the above-mentioned themes from a variety of empirical angles. While the editors make no such classification explicitly, I found it useful to organize the individual chapters into those that examine the conditions for (different types of) investment in South-East Asia in general terms and those that focus primarily on the prospects for intra-regional cooperation.

The first category includes chapter two by Peter Buckley which addresses the challenges of the “new economy” for TNCs and its implications for South-East Asian policy makers; chapter three by Christopher M. Dent on the political economy of FDI in South-East Asia from an economic security perspective; chapter seven by Adam R. Cross and Hui Tan on the impact of China’s WTO accession on South-East Asian FDI; chapter nine by Nick Freeman on the prospects for FDI in the transition economies of South-East Asia; and chapter ten (also by Freeman) on foreign portfolio investment into the region.

Buckley’s contribution is interesting since it provides an account of the supply side of FDI (i.e. the underlying motives of TNCs to invest abroad) to a volume that is dominated by writings on demand side elements (notably host country policies that may attract foreign investors). However, as the assessments of investment opportunities are made inside companies, I believe that the book as a whole would have benefited from more analysis from an organizational perspective. For example, an examination of possible strategic considerations on the part of

TNCs in choosing China over South-East Asia would have been illuminating.

The two chapters by Freeman also deserve a special mention, since they help to nuance the broad-brush picture provided in the introductory chapter. The chapter on transition economies points to the need for recognizing South-East Asia's economic diversity and diverging experiences with FDI. The chapter on portfolio investment provides a refreshing break with the rest of the writings, which mostly consider FDI in isolation. (After all, several studies have found a consistently lower volatility of FDI flows into developing countries when compared with portfolio investment and loans, which raises the question of where policy reform efforts should be concentrated).

The contributions assessing intra-regional activities consist of chapter four by Amale Scally and Jayasinghe Wickramanayake, which examines the impact of the ASEAN Free Trade Area (AFTA) agreement on South-East Asian FDI; chapter five by Frank Bartels on intra-regional FDI patterns in South-East Asia; chapter six by Axèle Giroud on cross-border production networks in the region; chapter eight by Frank Bartels on intra-regional M&A activity; and chapter eleven by Kee Hwee Wee and Hafiz Mirza on the past, present and future of ASEAN investment cooperation.

A majority of these authors call for deepened collaboration among the South-East Asian countries in order to position the region (rather than individual countries) as a production base capable of matching China. A general sentiment is that South-East Asia ought to be a natural economic zone with vibrant intra-regional trade and investment flows. There is little evidence, however, that increased integration is under way, notably in terms of true policy harmonization beyond framework agreements, such as AFTA and the ASEAN Investment Area. As Hal Hill notes in the concluding chapter, an explanation for South-East Asian authorities' passivity might be found in the increased presence in recent years of the region's historically dominant investors: the United States and Europe (especially in

the wake of Japan's prolonged economic stagnation). In light of these developments, one might have asked for greater caution when considering whether "national treatment" for investors from neighbouring countries is the right way to go.

Altogether, this volume offers a wealth of qualitative and quantitative information on FDI in South-East Asia. It would perhaps have been helpful to the reader if the editors had addressed the imbalance among the various contributions. Notably, a few of the chapters contain overly long and detailed appendices which could have been reduced to provide room for more reflection and discussion. Taken as a whole, however, the topics covered fit well in the debate on the post-crisis South-East Asian investment environment.

Editing takes time. The fact that most data do not go beyond 2000 (with some ending already at 1997) makes it difficult to assess the robustness of the depicted trends. Therefore, I especially enjoyed reading the concluding chapter by Hill, which puts the conclusions drawn in the earlier chapters into a larger perspective. Drawing on his extensive track record in FDI research, Hill scrutinizes the contents of this book by asking the question: what sort of volume might this have been, had it been compiled 10, 20 or 30 years ago? Against the broader backdrop of South-East Asian development, his conclusion is that the worry over recent FDI decline seems exaggerated. It needs to be remembered that "crises present both challenges and opportunities [and] may well be accompanied by rising FDI" (p. 257). Likewise, with respect to the competitive threat posed by China, Hill argues that "it would be a mistake to overstate the concerns" (p. 259). On the contrary, he believes the big picture to be a positive-sum game, with pro-active South-East Asian countries having much to gain from two-way trade (including FDI flows) with China.

Hill wraps up with a discussion on an issue prevalent in South-East Asia's FDI regimes, but not addressed in much detail in the earlier chapters – the use of incentives. He argues that the deployment of various fiscal incentives to attract foreign

investors is symptomatic of on-going deficiencies in the business environments in several South-East Asian countries. Despite changes in the policy environment, the size and growth of domestic markets remain the main factors attracting FDI. The author's crude conclusion is that, in the long run, addressing the sources of any unattractive features of the host country investment climate is the only viable means for attracting TNCs, an assertion that is probably valid also outside South-East Asia.

My overall impression is that this volume will be of most value for those with a particular interest in intra-regional South-East Asian cooperation. I also consider it to be a good complementary read for anyone curious about current developments of FDI in the (former) "miracle" economies of South-East Asia.

Anna Krohwinkel-Karlsson

Institute of International Business
Stockholm School of Economics
Stockholm, Sweden

***Managing the Road to Globalization:
The Korean Experience***

Wan-Soon Kim and Michael Jae Choo, editors
(Seoul, Korean Trade-Investment Promotion Agency, 2002),
271 pages

The Asian financial crisis of 1997 and its repercussions for the economy of the Republic of Korea led to significant reforms of the country's economic make-up and the opening-up to foreign direct investment (FDI). New institutions were established to reach out to foreign investors, including the Korean Investment Service Center (1998) and the Office of the Investment Ombudsman (1999). The main author of this book, Wan-Soon Kim, is the first Foreign Investment Ombudsman of the Republic of Korea. The book is, to a large extent, his reflections on how Korean society has been handling foreign economic interventions, including FDI, and how globalization has influenced Korean norms, rules and practices as well as its institutions. The co-author of this book is Michael Jae Choo, Communications Manager of the Office of the Investment Ombudsman. He contributed a number of articles, which were originally published as an "Ombudsman Diary" newspaper column.

Most of the 67 articles in the book had already been published in *The Korea Times* and *The Korea Herald* (2001-2002) and are, in the first instance, written for a domestic audience. In order to open up to an international readership, the authors grouped the articles around a number of subjects that provide the reader with a good look into the Korean experience with globalization and FDI. They managed to provide a window to the Korean mindset, the country's public services and business practices; but it does not escape the reader that the underlying lessons of the book are addressed to the Korean public, politicians, government officials and business leaders.

The book consists of six parts. Part I gives a short overview of the conditions that led to the financial crisis of 1997, the liberalization of Korea's FDI regime in the late 1990s and the remaining obstacles to FDI. This section often praises the political achievements made in opening up the economy against the backdrop of a suspicious general public, bureaucracy and opposition from special interest groups, such as trade unions.

What follows in Part II is a series of short stories, sometimes anecdotal, explaining the Korean mindset and how this often slows down "The winds of change"¹ as explained in an article on how the Government half-heartedly reacted to FDI proposals in the renewable energy sector. In these articles, the Investment Ombudsman is highly critical of his countrymen's attitude to anything foreign. No parts of Korean society are spared, including the media.

In a number of articles dealing with the Korean business sector and transnational corporations (TNCs) operating in the country (Part III), the Investment Ombudsman signals several key problems in the corporate culture, in government and in business-labour relations. In an article entitled "Clear as mud",² he addresses, for example, the loss of international investment opportunities due to a lack of transparency in policies and regulations governing business and due to poor company accounting and shady business practices. He also presents solutions to problems, sometimes based on best practices by TNCs operating in Korea, such as in an article on labour relations.³

Despite the critical tone in most parts of the book, there are also articles, in Part III, in which the strong sides of the Korean economy, such as the country's competitiveness in the information technology industry⁴ and its sophisticated

¹ "The winds of change", pp. 68-70.

² "Clear as mud", pp. 105-107.

³ "Foreign-invested firms gaining industrial peace", pp. 114-116.

⁴ "Technology development and the role of information", pp. 127-129.

manufacturing sector, are highlighted. The authors make suggestions on how to stay competitive⁵ and how the country could strengthen its position among competing nations in the region.⁶

In Part IV, articles relate to one of the main functions of the Korean Office of the Investment Ombudsman, “to serve as a trouble-shooting mechanism to improve or transform the quality of regulations in Korea” (p. 141). Case studies are based on complaints received by the Office and provide an insight into the role of an Investment Ombudsman. It is apparent from reading the book that an Investment Ombudsman needs to have many human qualities as a broker between government and business, but the person also needs to have a strong and consistent message. This message “in favour of liberalization and the removal of obstacles to business” is very up-front in Part IV and may, to some readers, be somewhat repetitive. This, hopefully, will not discourage readers, since the authors address a number of issues that also have relevance outside the Republic of Korea, for instance, with respect to taxation policy and the role of local government in attracting FDI.

In Part V, the benefits of FDI are highlighted, often by referring to success stories in other countries. The authors particularly like to draw lessons from the experiences of small to medium-sized countries. Ireland is repeatedly used as an example. There are also special articles devoted to Costa Rica⁷ and the Netherlands,⁸ which, according to the authors, have managed to advance economically through favourable FDI policies, a welcoming attitude and the adoption of modern international business practices.

In every country, developed or developing, an important issue in the discussion on FDI is how local companies can benefit from the presence of TNCs. The authors cover some ground on

⁵ “Countering the ‘brain drain’ effect”, pp. 120-123.

⁶ “Transforming Korea into a design Mecca”, pp. 130-132.

⁷ “Costa Rica: a flourishing FDI frontier”, pp. 219-222.

⁸ “Benchmarking the Netherlands”, pp. 229-231.

this in a piece on business linkages between local firms and TNCs.⁹ It is interesting to note that, in this article, not only do the authors advise the Government to set up a comprehensive linkages programme following the example of a growing number of Asian, European and Latin American countries, but also “and not for the first time in this book “express their reservations on the industrial complexes for TNCs in the Republic of Korea, which, according to them, “may in actuality be highly non-conducive to spillover effects due to their isolated nature” (p. 202).

The last part of the book deals with social and cultural issues related to the globalization process. The Republic of Korea is benchmarked on a number of issues, using international indices measuring the globalization level of the country, standards in the educational system, living conditions for foreign investors and female participation in the economy, again in an attempt by the authors to highlight shortcomings in the country that may have a negative effect on FDI. In the last article of the book, Kim talks about the absence of a tipping culture in the Republic of Korea and how the introduction of it may improve the quality of services by, for instance, employees in the food and beverage industry and taxi drivers. Given the social and cultural history of the country, he finds it unlikely that it would be easy to introduce a tipping system from within and expresses the hope that “visitors” to the country will introduce the practice. He also mentions that, on a solo grassroots crusade, he often provides a tip himself with the hidden motive of spreading the custom.

Although the messages in this book are directed at Korean readers, many of the issues raised are universal. The experience of the Republic of Korea with FDI-led globalization will help others to understand the problems faced in emerging economies that are similarly trying to attract FDI and benefit from it. What is missing is an account of the success that the Office of the Investment Ombudsman had in resolving difficulties

⁹ “Linking an economy: FDI in action”, pp. 200-203.

experienced by foreign investors and in helping to improve the investment environment.

This book is a good example of the work that the Office of the Investment Ombudsman does. One could think of a number of countries that might consider a similar critical look at how they are managing the road to globalization.

Paul Wessendorp

Regional Coordinator
Investment Promotion
United Nations Conference on Trade and Development

JUST PUBLISHED

TNCs and the Removal of Textiles and Clothing Quotas

Sales No. E.05.II.D.20

This study argues that the removal of import quotas on clothing and textiles is likely to lead to greater dominance by transnational corporations (TNCs) relying on economies of scale and consolidating production in larger factories in countries where economic fundamentals are sound. In numerous developing countries, clothing and textile production is already dominated by East Asian TNCs that operate factories. It is noted that the dismantling of quotas on 1 January 2005, following the expiration of the WTO Agreement on Textiles and Clothing, is expected to increase competition for the foreign direct investment (FDI) that drives production and exports in the clothing and textile sectors. Furthermore, it predicts that the end of the quotas will lead to tougher requirements on countries that aspire to be export bases for such products.

An Investment Guide to Kenya

UNCTAD/ITE/IIA/2005/2

Kenya is the leading economy in East Africa. Its strategic location and its well-developed business infrastructure make it a natural choice for investors and many international firms have made it their regional hub. Investing in Kenya now also provides access to the larger regional market of the East African Community, which was formed by its three partner states (Kenya, Tanzania and Uganda) in 2000 and which has 93 million consumers. The EAC customs Union came into effect in January 2005 and the EAC is expected to form a political federation by 2013. As a member of the Common Market for Eastern and Southern Africa (COMESA), Kenya also gives investors access to a further 385 million consumers.

But Kenya has much more to offer than its membership of regional trading blocs. Foreign investors routinely refer to people

as Kenya's greatest asset: its workers are among the best educated and most enterprising and hard-working in Africa. The climate and soil in many parts offer ideal conditions for agriculture, as demonstrated by the success story of horticulture and, in particular, floriculture. Kenya also has significant natural assets for attracting tourism, such as the Maasai Mara and the Mombasa coast. Other investment opportunities can be found in manufacturing and infrastructure.

Kenya also offers some serious obstacles to investors. The transport infrastructure is the major obstacle, especially roads, which are in bad shape even by regional standards. Governance and security are other important issues, although the Government has adopted various measures for fighting corruption and controlling crime.

An Investment Guide to Tanzania
UNCTAD/ITE/IIA/2005/3

The United Republic of Tanzania, formed in 1964 by the union of the newly independent Tanganyika and Zanzibar, is a model of successful democratization and steady growth in Africa. For almost half a century, Tanzania has enjoyed political stability, including ten years of multi-party democracy. The rule of law is also well-established in Tanzania and the level of security is notably higher than in its neighbouring countries.

Tanzania's membership in regional trading blocs, along with its geographic location, makes the country a strategic destination for investment. Tanzania offers a domestic market of 36 million consumers. Investors in the country also enjoy access to the 93 million consumers of the East African Community (EAC) – which Tanzania founded in 2000 with Kenya and Uganda – and to the 215 million consumers of the Southern African Development Community (SADC). Besides its 1,400 kms of coastline on the Indian Ocean, Tanzania is also blessed with other exceptional natural assets, making the country one of the finest tourist destinations in Africa. Twenty five per cent of Tanzania's total area is set aside as national parks and game

reserves (which include the famous Mt Kilimanjaro and the Serengeti plains). Mining is a field attracting a number of foreign investors, with Tanzania the third largest gold producer in Africa. There are opportunities as well in agriculture and infrastructure.

Difficulties facing investors in Tanzania include the transport infrastructure, limited labour skills and bureaucracy. But Tanzania's prospects are bright. At the domestic level, it has a steadily growing economy and foreign direct investment is a success story. At the regional level, investors can expect further integration of the EAC, which established a Customs Union in January 2005 and is expected to form a political federation by 2013.

An Investment Guide to the East African Community (EAC)
UNCTAD/ITE/IIA/2005/4

The East African Community (EAC), composed of Kenya, Tanzania and Uganda, came into existence in July 2000, upon ratification of the EAC Treaty by the three partner States.

The EAC covers a total area of 1,768,812 sq. kms and is inhabited by 93 million people. Located below the Horn of Africa and blessed with a coastline of 2,104 kms on the Indian Ocean, the region is endowed with some remarkable physical features. It contains, for example, Lake Victoria, the largest lake in Africa and the source of the river Nile. The climate and soil in much of the region are ideal for agriculture, while the wildlife in its forests and savannahs is an enormous asset for tourism. The EAC is also richly endowed with a variety of natural resources like gold, oil and gas.

Constraints on investment include poor infrastructure, especially in transport and power, weak administration and persistent corruption. Against these, however, should be set the strong advantages, which include a skilled and enterprising workforce in Kenya, one of the most liberal African economies in Uganda and political stability in all three countries.

The basic objective of the Community is to move towards full integration. The first step of the integration process was achieved with the establishment of the Customs Union in January 2005. The EAC Fast-tracking Committee has recommended a road map which would lead to Political Federation by 2013. At their most recent Summit in May 2005, the Presidents of Kenya, Tanzania and Uganda confirmed their commitment to fast-tracking the integration process.

Press materials on FDI issued in March 2005 to July 2005
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CHINA IS NOT CROWDING OUT FDI FROM THE REST OF EAST ASIA, EXPERTS SAY	07/03/05	UNCTAD/PRESS/IN/2005/007

Books received since April 2005

Ietto-Gillies, Grazia, *Transnational Corporations and International Production* (Cheltenham, Edward Elgar, 2005), xii+252 pages.

Meggison, William L., *The Financial Economics of Privatization* (Oxford and New York, Oxford University Press, 2005), x+522 pages.

Moran, Theodore H. and Gerald T. West, eds., *International Political Risk Management: Looking to the Future* (Washington, D.C., World Bank, 2005), xi+251 pages.

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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.

United Nations Centre on Transnational Corporations (1991). *World Investment Report 1991: The Triad in Foreign Direct Investment*. Sales No. E.91.II.A.12.

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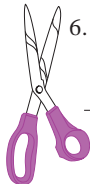
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Printed at United Nations, Geneva
GE.05- – August 2005 – 3,350

United Nations publication

UNCTAD/ITE/IIT/2005/ (Vol. 14, No. 2)

ISBN 92-112690-8

ISSN 1014-9562