Multilateral investment agreements and regional economic integration

Joachim Karl*

The multilateral approach towards an investment agreement raises the question whether—like in trade—a regional economic integration organization like the European Union would need a so-called regional-economic-integration-organization clause which would allow it to continue with its internal investment liberalization at a faster pace than with regard to European Union outsiders. Although from a purely economic point of view any discrimination against non-European Union investors could hardly be justified, there may be reasons deriving from European Union law that make such different treatment necessary. Despite the fact that the main competence concerning the regulation of investment from outside the Union rests with the member States, both the European Community Treaty and the European Union Secondary Legislation affect such investment activities.

The European Community Treaty itself would not forbid granting non-European Union investors the same treatment than their European Union counterparts. However, European Community Treaty rules on establishment go beyond the traditional concept of non-discrimination by obliging member States to abolish any unjustifiable obstacle for foreign investment. Moreover, the European Union internal investment liberalization is at least partially based on the concept of mutual recognition which—by definition—can only apply to those States adhering to these standards. It is therefore reasonable that non-European Union investors do not receive these advantages on a unilateral basis via the most-favoured-nation principle.

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* Dr. Jur., Federal Ministry of Economics, Bonn, Germany. The author expresses his personal views, and wishes to thank Ms. J. Swanberg, Cambridge, Mass., for her help in preparing this article.

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However, a regional-economic-integration-organization clause to avoid such an outcome should be defined as narrow as possible. This might be achieved by limiting the most-favoured-nation treatment granted to non-European Union investors either by the European Union or its member States in such a way that it does not go beyond national treatment. Furthermore, non-European Union investors would not be allowed to benefit from any particular liberalization method that necessarily requires European Union membership.

Introduction

More than two years after the successful conclusion of the Uruguay Round, the idea gains momentum to establish multilateral rules for foreign direct investment (FDI). There is a growing awareness that what has been achieved in the trade field is also needed with respect to international investment, and that trade liberalization is incomplete as long as it is not supplemented by similar agreements concerning FDI (Brittan, 1995). The close interdependence between trade and investment calls for an organic approach, covering both aspects of international economic activity. Also, investment operations of transnational corporations (TNCs) are increasingly based on complex strategies, involving more than just two countries (UNCTAD-DTCI, 1993). As a consequence, the traditional bilateral approach to investment protection becomes less appropriate and sufficient.

The first steps to develop multilateral investment rules have already been undertaken, such as the GATT-Agreement on Trade-Related Investment Measures (TRIMS), the GATT-Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), the General Agreement on Trade in Services (GATS), and the Energy Charter Treaty which was signed in December 1994 in Lisbon. However, what has been missing so far is a broad multilateral investment agreement which goes beyond the limits of a mere sectoral arrangement (like the Energy Charter Treaty or the GATS), or that deals not only with certain specific aspects of investment activity (like the TRIPs or TRIMS Agreements).

It was therefore an important event when OECD started in September 1995 with negotiations on a Multilateral Agreement on Investment (MAI) (Witherell, 1995). The goal is to develop, by spring 1997, state-of-the-art rules on investment liberalization, investment protection and dispute settlement in order to promote further, and encourage, cross-border investment (Brewer and Young, 1995; Kline, 1993; Fatouros, 1995). The future agreement shall be open for accession by non-member countries. Investment issues will probably also be on the agenda for the WTO Ministerial Conference in December 1996 in Singapore.

This article discusses one particular issue currently under negotiation. The question is whether a regional economic integration organization, such as the European Union, needs to deviate from the most-favoured-nation (MFN) principle in order to preserve its capability to move ahead with its internal investment liberalization at a faster pace than other States are ready to go. Or, in other words, is there any reason why, in a multilateral investment agreement, a distinction should be made between those partners belonging to a regional economic integration organization, and those that do not have this status? In a more general sense, what is at stake is once again the delicate relationship between multilateralism and regionalism.

There are few issues in the field of international investment policy that produce such lively debate between governments. On the one hand, there are the defenders of a so-called ''regional-economic-integration-organization'' (REIO) clause who argue that, without such a provision, it would come to a mechanical and automatic extension of benefits of regional economic integration to third countries without the latter acceding to the obligations of the integration agreement. A REIO clause would therefore be justified because it prevents free riding. On the other hand there are those who oppose a REIO clause by arguing that there is no reason for having such a clause in the investment field. It would, so they say, also be contrary to a core principle of any international agreement, that is the establishment of equal rights and obligations between all negotiating partners. A REIO clause would be a broad, open-ended exception to the MFN principle, and could therefore be a deal breaker for any multilateral investment agreement.

In the remainder of the article, an attempt is made to find out whether there is a need for a REIO clause in the context of FDI. As there is no uniform definition of a REIO, an answer can only be given with regard to a concrete organization—in this case the European Union which is undisputedly the most advanced REIO. However, by identifying situations where a

REIO clause might be needed by the European Union, conclusions may be drawn concerning the possible need to cover REIOs with a looser form of cooperation—such as a free trade zone or a customs union—as well.

The present situation

There exist already today several REIO clauses with respect to international investment. For example, they can be found in most bilateral investment protection agreements where it is usually said that the principle of non-discrimination shall not apply to privileges which either party accords to investors of third countries on account of its membership of a customs or economic union, a common market or a free trade area. On the multilateral level, one example is article 10 of the OECD Code on Liberalization of Capital Movements[1] which allows for special treatment of members of a special customs or monetary system. On the other hand, article V of the GATS,[2] and article 25 of the Energy Charter Treaty[3] require that the

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[1] All legal instruments with respect to international investment are published in UNCTAD, 1996; article 10 reads as follows: "Exceptions To The Principle Of Non-Discrimination: Special Customs or Monetary Systems Members forming part of a special customs or monetary system may apply to one another, in addition to measures of liberalization taken in accordance with the provisions of article 2(*a*), other measures of liberalization without extending them to other Members. Members forming part of such a system shall inform the Organisation of its membership and those of its provisions which have a bearing on this Code."

[2] The most important provisions of article V are paras. 1 and 4: "This Agreement shall not prevent any of its members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement, provided that such an agreement: (*a*) has substantial sectoral coverage, and (*b*) provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII, between or among parties, in the sectors covered under subparagraph (*a*), through (i) elimination of existing discriminatory measures, and/or (ii) prohibition of new or more discriminatory measures, either at the entry into force of that agreement or on the basis of a reasonable time-frame, except for measures permitted under Articles XI, XII, XIV and XIV *bis*."

Para. 4: "Any agreement referred to in paragraph 1 shall be designed to facilitate trade between the parties to the agreement and shall not in respect of any Member outside the agreement raise the overall level of barriers to trade in services within the respective sectors or subsectors compared to the level applicable prior to such an agreement."

[3] Article 25 reads as follows: "Economic Integration Agreements (1) The provisions of this Treaty shall not be so construed as to oblige a Contracting party which is a party to an Economic Integration Agreement (hereinafter referred to as 'EIA') to extend, by means of the most-favoured-nation treatment, to another Contracting party which is not a party to that EIA, any preferential treatment applicable to the parties to that EIA as a result of their being a party thereto; (2) For the purposes of paragraph (1), 'EIA' means an agreement substantially liberalizing *inter alia* trade and investment, by providing for the absence or elimination of substantially all discrimination between or among parties thereto through the elimination of existing discriminatory measures and/or the prohibition of new or more discriminatory measures, either at the entry into force of that agreement or on the basis of a reasonable time-frame; and (3) The application of the GATT shall not be affected by this Article."

regional economic integration organization substantially liberalizes both trade and investment.

This variety of organizations that have the right to discriminate against investors not belonging to a regional economic integration organization is astonishing. One should think that, because only different treatment in the area of FDI is at stake, only such an organization could ask for a REIO clause that has particular rules of how to deal with FDI. However, the above-mentioned examples are much broader. Sometimes, the existence of a mere free trade zone is sufficient for allowing discriminations. In other agreements a substantial liberalization of both trade and investment is required, or the existence of a special monetary or customs system. But where is, for example, the link between the existence of a free trade zone and the necessity to discriminate against foreign investors? It is also surprising that these REIO clauses do not distinguish between trade and investment at all—as if it were obvious that the need to discriminate exists likewise in both areas.

One reason for this combined approach probably is that the very idea of a REIO clause derives from the trade field. The best-known example is still article XXIV of GATT. According to paragraphs 5 and 6, GATT does not preclude member States from forming a customs union or free trade zone provided that the duties and other regulations of commerce imposed on the other contracting parties shall not be higher or more restrictive than the corresponding duties and regulations prior to the formation of such union or free trade area. The importance of article XXIV of GATT has recently been underlined by the fact that the Final Act of the Uruguay Round contains a detailed Common Understanding on this provision.[4]

The rationale of article XXIV of GATT is that deviations from the principle of non-discrimination are justified if they do not have a negative impact on trade with those States not belonging to the customs union or free trade area. A precondition for allowing regional integration schemes under GATT, therefore, is that they do not result in trade diversion, or that any such effect is offset by at least the same amount of trade creation (Viner, 1950). Ever since this concept was developed in the 1950s, virtually all customs unions or free trade areas successfully passed this test. A common procedure for checking whether a regional economic integration zone is

[4] The Common Understanding mainly relates to the evaluation of the effects of the duties and tariffs, review procedures, and dispute settlement.

covered by article XXIV of GATT is to compare trade with non-member countries before and after the organization's creation. There is a presumption that the integration area meets the GATT requirements if the effect of the union or free trade area is limited to an increase in trade within the region. Conversely, the integration area *prima facie* fails to pass the test if it results in replacing trade with non-member States by internal trade flows (Krugman and Obstfeld, 1991, p. 231). It is frequently argued that regional economic integration organizations almost inevitably increase trade with non-members because internal integration furthers economic growth which itself would result in a higher demand for imports from outside the region (Institute for World Economy, 1993; Hilpold, 1993, p. 657). The question is whether these arguments have any relevance with regard to investment.

At least at first sight equal treatment of trade and investment issues seems to be misplaced in the present context. With regard to trade it makes sense from an economic policy perspective that members of a regional economic integration organization do not extend their internal tariff liberalization to outsiders because, otherwise, they would unilaterally open their markets to non-members without gaining the same access to the respective export markets for their products. The principle of ''give and take'' which is reflected in this line of thinking, is inherent to trade as the latter can be defined as mutual exchange of products (Bhagwati, 1988, p. 39).

Moreover, unilateral trade liberalization is more difficult to pursue than unilateral investment liberalization because the former may raise demands to increase domestic taxes in order to make up for the loss of revenues. Furthermore, domestic producers of import-substitution products need either to increase their efficiency or to diversify into other products. This makes their opposition stronger than in the case of investment liberalization where foreign affiliates in the host country have to operate in the same competitive environment than domestic enterprises (Institute for World Economy, 1994, p. 5). Another difference between trade and investment liberalization lies in the fact that neo-mercantilism states that an increase in exports is the main goal of trade policy, and that unilateral trade liberalization causes more costs than benefits (Institute for World Economy, 1993).

In a similar spirit, OECD rejected the concept of reciprocity—which is a characteristic of trade—in the area of investment. The benefits of FDI to the host country occur regardless of whether the home country of the particular company provides the same treatment to host country enterprises (OECD, 1993, p. 24). Furthermore, reciprocity in the area of investment would be much more difficult to attain given the fact that the legal rules governing investment are much more complex and numerous than those in the field of trade (Fatouros, 1995).

There are other reasons why the principle of reciprocity obviously plays a weaker role in the area of FDI. Whereas imports are sometimes regarded with suspicion, or are even prohibited, FDI is nowadays welcome almost everywhere. As foreign entrepreneurs bring with them jobs, technology and knowledge, and as they possess their own international distribution channels (OECD, 1992), host countries court them. The positive effects of being a host to foreign investors occur irrespective of whether domestic entrepreneurs have equal access to third countries. Whereas a huge current account deficit is hardly sustainable over a longer period of time (Krugman, 1994, p. 45), a net inflow of FDI is usually regarded as a positive signal concerning the attractiveness as an investment location. Conversely, a net outflow of FDI may raise concern that jobs are exported abroad and that there is something wrong with the domestic investment climate.[5]

If foreign investors are welcomed in any particular host country why should a regional economic integration organization want to retain the possibility to exclude investors from non-member States from the benefits of its internal liberalization? Does it not harm its own interests because the regional economic integration organization makes itself less attractive for outsiders and therefore deprives itself of the economic benefits that go along with such investments? In this respect, one also has to take into account the quantitative importance that FDI has gained nowadays: outward FDI stock in 1995 reached $2.6 trillion (UNCTAD, 1995).

Possible justifications for a REIO clause

Economic considerations

Impact on the domestic economy

One argument sometimes used against FDI is that it may result in a firesale of domestic assets. There may be a certain psychological barrier in

[5] See, e.g., the present debate in Germany as to what extent high taxes and high labour costs cause investors to leave the country.

many countries to accept too much FDI. However, it is difficult to see why such possible psychological effects would be different, depending on whether investors come from a REIO member State or not.

How to identify the nationality of a company is another problem. At first, it seems to be clear that a company has the nationality of the country where it is located. However, it may well be that the shareholders of a foreign company have the nationality of the host country. The question therefore arises: who is us? (Reich, 1991, p. 1). Also, the common understanding that a 10 per cent foreign ownership share makes a company foreign-owned can lead to misperceptions. International treaties, like NAFTA (Article 1139) or the Energy Charter Treaty (Article 1, para. 6) simply state that a company is foreign if it is owned or controlled by foreigners. No further guidelines are given as to what control means.

Import propensity

Recent research has shown that foreign affiliates tend to have a higher propensity to import than domestic firms (Graham and Krugman, 1991, p. 64). This may result in a deterioration of the current account balance, and in a devaluation of the domestic currency. However, it is not clear whether the effects of a higher import propensity would be different depending on whether or not the parent company of a foreign affiliate is located inside or outside a regional economic area. In any event, for the individual host country, this may not matter much. The distinction may be important from a regional perspective: internal trade deficits may be easier to handle than those with third States. There are internal procedures to assist a member State having a negative current account, for instance financial aid, or—as in the case of the European Union—adjustments of the European Monetary System. Nevertheless, the distinction between imports originating inside or outside the regional area is of little relevance in this context: when a foreign investor is admitted to the host country it is hard to predict whether it will import mainly from inside the area, even though the fact that a parent company is located in the area may be an indication that the bulk of its affiliates' imports comes from the home country. However, this need not be the case given the fact that TNCs often have a global supply and distribution network.[6] The same holds true with regard to their export activities.

[6] According to the European Commission, at least 40 per cent of world-wide trade takes place within at least 350 transnational corporations; see EC-Commission, 1994, p. 13.

Strategic investment policy

Both in the academic and political arena, voices are becoming louder in favour of a more active role of the State in industrial policy (Young and Hood, 1993; Agosin and Prieto, 1993). They point out that the market is particularly inefficient in identifying long-term potential comparative advantages. Such policy considerations extend to the area of FDI (Dunning, 1992). The way to go—it is suggested—is through stimulating investment in industries in which countries can acquire a comparative advantage. In such areas, a temporary subsidy may result in a permanent advantage (Krugman, 1994, p. 131). Furthermore, even a head-start position of a competing country may be reversed.

There are, in general, two categories where strategic investment policy may make sense:

- First, there are cases where the growth of a new industry creates considerable externalities (Krugman and Obstfeld, 1991). An enterprise considering to invest in this industry may refrain from doing so because otherwise it risks not fully internalizing its research-and-development expenses. It must also share the benefits of the newly developed technology with other competitors. The investor's home country, having an interest in the development of the technology, might therefore be willing to take over part of the necessary development costs.

- Second, there are situations where, because of a specific market failure an industry has developed an oligopolistic structure (Krugman and Obstfeld, 1991). A government that sees a good chance that its domestic enterprises may successfully compete in that industry may consider subsidizing domestic producers. This may enable them to overcome the existing barriers to market entry.

The question is whether it would make sense to exclude affiliates of a non-member investor from such subsidies. At least in the European Union, such an attempt has never been undertaken so far. Because it is more important that the particular product be developed in the region, as opposed to who the producer is, a REIO clause would also make little economic sense. Moreover, European Union law would not allow for a different treatment of enterprises established in the Community depending on the nationality of the shareholders (see below). Finally, it is very difficult to estimate the chances of a newcomer to compete successfully in an oligopolistic market (Bhagwati, 1988).

Reciprocity considerations

During the past few years, reciprocity requirements have become more frequent as a means to open up foreign markets aggressively. In the area of FDI, this means that foreign investors will only be admitted in a host country to the same extent as domestic investors receive the permission to operate in the respective third State (Prestowitz, 1992, p. 67; United States, Congress, 1993, p. 18; Ebenroth, 1989, p. 729; European Commission, 1995, pp. 11, 42). Such reciprocity considerations are not in contradiction of what has been said above about the general favourable attitude of potential host countries to FDI. While a positive response to foreign investors exists in general, there may nevertheless be a demand for protection in certain industries. Examples include the European Union Second Banking Directive[7] or some research- and-development subsidies in the United States.[8]

Reciprocity considerations gain particular weight in the context of regional integration. In particular, one might argue that any future investment liberalization in a regional economic integration area only takes place when all members undertake the same obligations. Under this concept, it would indeed be doubtful whether outsiders could or should benefit from this kind of liberalization. These issues will be dealt with in more detail in the following section.

Legal considerations: the example of the European Union[9]

At first, there could be doubts whether legal considerations should matter in the present context: even if the law allows or even requires a different treatment of investors from inside and outside a regional economic in-

[7] Directive 77/780/EC of 12 December 1977; Official Journal Legislation (OJ L) 323, 17 December 1977, p. 30.

[8] See, e.g., the American Technology Preeminence Act of 1991, or the Advanced Manufacturing Technology Act of 1992.

[9] In the following, both the terms "European Union" and "European Community", in particular "European Community Treaty" will be used. The term "European Union" was introduced in 1993 by the Maastricht Treaty, and stands for a new political union whose competences now include areas of foreign and security policy as well as internal affairs and legal matters. Investment issues are still governed by the "European Community Treaty". Furthermore, all European legislation that has entered into force before the Maastricht Treaty will be referred to as acts of the "European Community".

tegration area, such rules could always be changed. However, the present situation may reflect a long-term REIO policy, and may well have its justification. Moreover, any attempt to change this might meet resistance from at least some member States. It is therefore important to know to what extent, and in what areas, EU law calls for or results in a different treatment between internal and external investors.

However, before doing so, it might be helpful to give a brief overview on how the European Community Treaty deals with investment matters in general. In order to achieve a borderless internal market, the European Community Treaty stipulates four basic freedoms: the free movement of nationals, including employees; the free movement of services; the free movement of capital; and the free right of establishment. In principle, these freedoms mean that, with regard to the before-mentioned activities, member countries are not allowed to discriminate between their own nationals and enterprises, and those from other European Union member States. The freedoms apply only to activities within the European Union. In general, non-European Union nationals and companies located outside the European Union cannot claim these rights—except the freedom of capital movements which applies also in respect to third countries.

With regard to the laws governing FDI, one can in general distinguish rules relating to the establishment of an investment, and those concerning the post-establishment phase. While there can be different treatment for domestic and foreign investors in both respects, such differentiation can be found more frequently with regard to the making of an investment. Conversely, once an investment is made, it usually receives the same treatment as any other domestic investment. This is certainly true for the European Union where, according to Article 58 of the Treaty concerning the European Community, companies established in the Union are treated as if they were European Union nationals. The following sections—which take the European Union as an example for a REIO—therefore concentrate on the treatment in the pre-establishment phase.[10]

One can put aside such pre-establishment cases where both the investors and their investments are located within the Community. Since all companies already established in the Community have to be treated alike,

[10] However, this does not mean that there would be no different treatment between European Union- and non-European Union-investors in the post-establishment phase at all. See the following section.

this treatment also applies with regard to the making of an investment. Yet there is one important exception concerning investments made by natural persons. Article 52 of the European Community Treaty grants the right of establishment only to those natural persons who have the nationality of a member State. Nationals of third countries are not covered, even if they have their residence in a European Union member State. Therefore, natural persons who are not European Union nationals and who would like to make an investment within the European Union would not have the same rights as their European Union counterparts. This might be a first case where a REIO clause is required.

With regard to the first establishment of non-European Union investors in the Union, the general rule is that European Union law does not deal with this situation. In principle, the European Community Treaty is only concerned with internal investment liberalization. It is therefore the law of the member States that governs the establishment of non-European Union investors in the first place. The question is whether there are any reasons why they should not grant under their national laws the same rights to non-EU investors that they are required to give to EU-investors according to European law. It is therefore necessary to examine the concept of EU investment liberalization in more detail.[11]

European Community Treaty

There are several European Community Treaty core provisions that may be relevant: the right of establishment (Article 52 *et seq.*), the right to provide services (Article 59 *et seq.*), and the right of free capital movement (Article 67 *et seq.*). Furthermore, the rules governing the free movement of goods (Article 30 *et seq.*) and persons (Article 48 *et seq.*) might play a role.

The freedom of establishment

Article 52 of the European Community Treaty prohibits any discrimination with regard to the right of establishment of European Union nationals and companies within the Union. In addition, Article 53 contains a *stand-still-clause* that forbids the introduction of new restrictions. In all cases, it is

[11] A good overview concerning the legal treatment of foreign investment is given in the various *OECD Country Reviews on Foreign Direct Investment*, various years.

a precondition that the company or the natural person making the investment is located within the Community.

The field of application of Articles 52, 58 is broad. It not only covers the establishment of a company itself but also all circumstances that become relevant in connection with an establishment, such as social security issues, or the issue of permits of residence.[12] More particularly, Articles 52, 58 forbid to make the right of establishment subject to a reciprocity requirement.[13] Also, Articles 52, 58 deal with both legally independent and dependent subsidiaries or branches.[14]

Articles 52 *et seq.* apply with regard to investments made by natural persons or companies located within the Community. However, the European Union and its member States have already extended the right of establishment to outsiders on various occasions in association agreements, or in the Treaty establishing the European Economic Area.[15] They could do the same in any other multilateral investment agreement. Whether or not they should do so depends on the concrete nature of the rights and obligations under Article 52 *et seq.*

Initially, the content of Article 52 seems to be clear. This provision reflects the principle of non-discrimination, the starting-point for several decisions of the European Court of Justice on this matter.[16] However, the wording of Article 52 can also be interpreted in such a way as to include an obligation of member States to abolish progressively any existing restrictions for FDI in their countries—restrictions that are not necessarily limited to the denial of non-discriminatory treatment. Indeed, the European Court of Justice has started to move in this direction. In one case, the plaintiff challenged a provision in the law of a member State that prohibited lawyers from having more than one place of business. As a result, the plaintiff who practiced as a lawyer in member State A was not allowed to open a branch in member State B unless it gave up his initial business in member State A.[17] The Court held that this regulation violates Article 52 because it bars foreign

[12] European Court of Justice, Case 63/86 (1988), E.C.R. 29.

[13] European Court of Justice, Case 270/83 (1986), E.C.R. 273; Case C-58/90 (1991), E.C.R. 4193.

[14] European Court of Justice, Case 81/87 (1988), E.C.R. 5483.

[15] See, e.g., Article 44 of the Europe Agreement with Poland.

[16] European Court of Justice, Case 2/74 (1974), E.C.R. 631 (Reyners); Case 221/85 (1987), E.C.R. 719 (Commission *v.* Belgium).

[17] European Court of Justice, Case 107/83 (1984), E.C.R. 2971 (Klopp).

lawyers from exercising their right of establishment. In particular, the Court extended the rights of foreign lawyers beyond those that exist for domestic ones because the latter were still limited to only one place of business. This ruling was confirmed in a decision dated 30 April 1986.[18] Therein, the Court also ruled that restrictions for foreign investors are not allowed if they impede access to the host country more than necessary.[19] The conclusion to be drawn from these rulings is that Article 52 goes beyond the common principle of non-discrimination. It also encompasses the prohibition to introduce or to maintain any unjustifiable restrictions on foreign investment.

To return to the question whether or not it would be appropriate to extend Article 52 to non-European Union investors in a multilateral investment treaty, it is hard to imagine that there would be sufficient political support for such a decision. The European Union would grant rights to its non-European Union negotiating partners without receiving similar benefits. While non-European Union contracting parties would only be obliged to respect the principle of non-discrimination, European Union member States would have the additional obligation to abolish any unjustifiable investment restriction. This would not just be a special kind of non-discriminatory treatment, but something in addition, an *aliud*. In particular, the result could be reverse discrimination against European Union investors, i.e., there may be cases where non-European Union investors receive a better treatment in the Union than their European Union counterparts.[20] While such a reverse discrimination is acceptable between European Union members States because it applies in all member countries alike, it could hardly be justified to make such an important concession on a unilateral basis.

This has direct implications for the need to include a REIO clause into a multilateral investment agreement. If it is true that a unilateral extension of Article 52 is probably not acceptable to the Union, it seems that such a clause could hardly be avoided. However, it should be defined as narrow as possible. This could be achieved by making clear that with regard to non-European Union investors, MFN treatment is limited to the granting of national treatment. Non-European Union investors could therefore claim national treatment, but no treatment that exceeds it.[21] This would not impede

[18] European Court of Justice, Case 96/85 (1986), E.C.R. 1475.

[19] See also Bokelmann, 1990, p. 1021ff.

[20] See the above-mentioned case before the European Court of Justice, Affair 107/83.

[21] See Article 25 Energy Charter Treaty.

the Union and its member States to grant better than national treatment in specific cases on a voluntary basis.

The freedom to provide services

Like Articles 52 *et seq.*, Articles 59 *et seq.* do not deal with the supply of services between European Union member States and third countries. Non-European Union investors do therefore have no rights under these provisions.

Concerning the question of how the provisions on services relate to Articles 52 *et seq.* on establishment, the prevailing view seems to be that only the rules on establishment apply whenever a company or a natural person seeks a permanent location in the host country (Randelzhofer, 1982). Conversely, only the rules concerning services apply if the person or company concerned stays in the host country only temporarily. Although there may be cases where it is difficult to draw the borderline between a temporary and a permanent residence, the general rule is that Articles 59 *et seq.* do not apply with regard to investment, because the latter means a long-term engagement in the host country. On the other hand, if an investment is made to provide a temporary service, this would be covered. For example, a link between providing a service and making of an investment has been made in Article I.2*c* of the GATS.

The freedom of capital movement

Contrary to the Treaty provisions concerning establishment and services, Articles 67 *et seq.* contain explicit rules with regard to capital movement between the Union and third countries. According to Article 73*b*, all restrictions on the movement of capital and on payments between member States and between member States and third countries are prohibited.

One may ask whether the principle of free movement of capital encompasses the right of establishment in connection with FDI. Indeed, Annex I to European Union directive 88/361/EC[22] lists FDI as one possible capital-transfer transaction. Nonetheless, the prevailing view is that Articles 67 *et seq.* cover only such restrictions that are not already dealt with in Articles 52 *et seq.* (Ress, 1992, p. 16). Articles 67 *et seq.* deal with rules that are not

[22] Dated 24 June 1988, OJ L 178, 8 July 1988, p. 5.

directly concerned with establishment issues. Such rules are, e.g., foreign exchange regulations, rules concerning the stock exchange, or rules on investment funds (Weber, 1992, p. 561). This does not exclude the possibility that, in a concrete situation, both the rules on establishment and on capital movements apply. For example, the prohibition for foreign investors to acquire shares of a domestic company at the stock exchange could be in conflict with both sets of provisions.

Furthermore, Article 73*b* para. 2 contains a prohibition to restrict payments between member countries. Payments, in this respect, means only the transfer of money in a technical sense (Weber, 1992). None of these provisions necessitates a REIO clause because they do not distinguish between capital movements or payments by investors from European Union members and non-members.

Restrictions on capital movements between member countries and third countries are also dealt with in Article 73*c*. This provision allows for the maintenance of any restrictions that existed on 31 December 1993 under national or Union law adopted in respect of the movement of capital to or from third countries in connection with FDI, including, *inter alia*, establishment. However, as has been said above with regard to Article 73*b* (to which Article 73*c* makes reference), specific rules on establishment would not be covered by this provision. A mere prohibition to invest would therefore neither fall under Article 73*b* nor Article 73*c*.

Thus, Article 73*c* allows for the maintenance of discriminations against non-European Union investors with regard to capital movements in connection with an investment if such discrimination existed already on 31 December 1993. However, this does not necessarily mean that this is a reason why the European Union would need a REIO clause. Rather than aiming at discriminating against non-European Union investors, the main purpose of Article 73*c* is to ensure that non-European Union investors cannot claim a right of establishment via the rules on capital movement, keeping in mind that such a right does not exist according to Article 52. Article 73*c* has therefore mainly the character of a safeguard provision for the Union and its member States. Without it, there would be the risk that, by striking down the prohibitions on the free movement of capital, existing restrictions concerning the right of establishment could also no longer be maintained. The remaining restrictions on the establishment of non-European Union investors in the Union would be incomplete if the parallel restrictions on the movement of capital would no longer exist. Moreover, without Article 73*c* there would have been the risk that member States did not agree upon the principle of free movement of capital with respect to third countries at all, a provision that was adopted only in 1993 in the Maastricht Treaty.

That Article 73*c* does not intend to discriminate against non-European Union investors is underlined by the fact that, according to Article 73*b* para. 1, the principle is complete liberalization. Moreover, Article 73*c* contains a stand-still clause for member countries. Article 73*c* para. 2 emphasizes once more that the goal of the Union is liberalization to the greatest extent possible. In the exceptional case that the European Union would need to adopt new restrictions, unanimity is required.

It would therefore be sufficient for the Union and its member States to have a stand-still provision in a multilateral investment agreement that would allow to maintain existing restrictions—if such restrictions are considered to be still necessary. However, a best-efforts clause could be added to show the Union's willingness to abolish existing restrictions progressively.

The free movement of goods

Non-European Union investors that import goods from their home country into the Union in connection with an investment have to pay customs duties whereas European Union investors can do this freely. However, this discrimination is not based on the nationality of the investor. An European Union investor that imports goods from a third country would have the same obligation. Article 30 *et seq*. are therefore not relevant in this context.

This is also the reason why a mere free trade zone or a customs union should not be covered by a REIO exception with regard to FDI. These forms of economic cooperation do not necessarily go along with the establishment of special rules governing FDI. As they do not deal with the establishment of FDI, there is also no need to permit deviations from the principle of non-discrimination in this field.

The free movement of personnel

Employees that are nationals of a European Union member State are entitled to receive a work and residence permit if they want to work in an

European Union company, whereas non-European Union nationals do not possess these rights. However, once again this different treatment has nothing to do with the nationality of the company where workers seek employment. Both European Union and non-European Union investors are treated alike.

Two special European Union law characteristics: precedence and direct applicability

There are other special features of European Union law where it appears to be inappropriate to extend the benefits of internal liberalization to non-European Union investors, irrespective of whether liberalization goes beyond national treatment or not. One such principle is the precedence of European Union law *vis-à-vis* national legislation. The European Union has established a new international legal order according to which member States have to some extent renounced their national sovereignty. They have created a law that establishes rights and obligations not only for themselves but also for their nationals. This is different from traditional international law.[23]

A second important principle is the concept of direct applicability of European Union law. It means that if a particular provision of European Union law is sufficiently clear and drafted in an unconditional manner, it is able to create rights for individuals immediately. There is no need that the provision is transformed into national law first; the European Union law is directly applicable. This goes so far that European Union law overrides domestic law inasfar as the latter contradicts the former.[24]

Furthermore, European Union law even creates still more extensive rights for individuals in respect of European Community directives. By definition, an European Union directive addresses itself only to the member States and obliges them to pass—within a certain period of time—national legislation in accordance with the general goals of the directive (Article 189 European Community Treaty). If a member State fails to do so, the directive may become directly applicable as well, provided that the above-mentioned

[23] European Court of Justice, Case 6/64 (1964), E.C.R. 1253 (Costa/Enel).

[24] European Court of Justice, Case 26/62 (1963), E.C.R. 1 (van Gend); Case 106/77 (1978), E.C.R. 629 (Simmenthal).

requirements are fulfilled[25]. So far, the result would not be different from the direct applicability of the European Community Treaty provisions themselves.

However, in a landmark decision the European Court of Justice decided a few years ago that if a member State violates its obligation to transform a directive into national law in due time, it may be obliged to pay compensation to an individual who suffered damages because of the delay. This obligation exists if the directive intends to create rights for individuals, if these rights can be properly identified, and if the damage was caused by the member State's failure to respect the time limits of the directive.[26]

Would it be appropriate that non-European Union investors benefit from these concepts, i.e, that they can claim via the MFN clause the direct applicability of the provisions of a multilateral investment agreement, including, maybe, even the right of compensation? Once again, it seems that the outcome would be a severe imbalance of contractual obligations of the European Union member States on the one hand, and the non-European Union contracting parties on the other hand. The far-reaching obligations that the European Union member States would undertake in respect of non-European Union investors would in no way be matched by similar duties of other contracting parties. The principles of precedence of European Union law, its direct applicability and the above-mentioned obligation to pay compensation are unique features of the European Union. As these concepts have their origin and justification exclusively in the European Community Treaty, they cannot be unilaterally applied to non-European Union member States.

There is thus a second case for a REIO clause. There is a need for a derogation from the MFN principle where the European Union internally uses special liberalization methods that require European Union membership.

The European Union secondary legislation

The fact that the European Community Treaty itself aims only at internal investment liberalization does not impede European Union secondary

[25] European Court of Justice, Case 41/74 (1974), E.C.R. 1337 (van Duyn); Case 8/81 (1982), E.C.R. 53 (Becker).

[26] European Court of Justice, Case C-6,9/90 (1991-I), E.C.R. 5357 (Francovich).

legislation on investment by non-European Union investors. Article 235 of the European Community Treaty gives the European Union the right to adopt rules with regard to investments by non-European Union investors if this is necessary to fulfill one of the aims of the Treaty. The Treaty goal with regard to investment is to abolish all internal restrictions between member countries. However, without special reference to investment from third countries, measures that member States have to take in the process of the European Union's investment liberalization programme would (in principle) apply to all investments in their territory, irrespective of their origin. To avoid this unilateral extension of benefits, it may become necessary to provide in European Union secondary legislation that the treatment prescribed for European Union investors does not automatically extend to outsiders, or to establish special rules for non-European Union investors. Apart from Article 235, Article 73*c* gives the European Union the right to adopt secondary legislation concerning capital movements in connection with non-European Union investors. In all these cases, the question is whether secondary legislation provides for additional examples to support the introduction of a REIO clause.

Secondary European Union legislation concerning FDI falls into four broad categories: rules dealing with company law; sectoral regulations; measures with regard to capital movements; and taxation.

Company law

> Secondary legislation in this area pursues the following goals: mutual recognition of domestic enterprises, coordination and harmonization of national company laws, facilitation of cross-border mergers and acquisitions, and creation of a European company model. The question is whether any of the existing legislation in this area discriminates against non-European Union investors, or whether such discrimination might happen in the future.
>
> In general, different treatment between European Union and non-European Union investors could be justified in those areas where internal investment liberalization is based on the concept of mutual recognition. In a nutshell, this concept means that, once a product or any other good is admitted in one particular member State, the other member States have—in principle—to admit this product or good also

in their respective markets.[27] Applied in the context of FDI, mutual recognition implies that member States may have to facilitate the establishment of other European Union investors once these investors comply with certain standards (e.g., with regard to the form of an investment, its corporate statutes, capital, legal responsibility, and general admission requirements) in their home country—provided that these general standards have been agreed upon by all member States. Obviously, only those countries can benefit from the concept of mutual recognition that apply this concept also for themselves. There is no free riding.

The most far-reaching implication of the concept of mutual recognition would be that companies established in one member country would be allowed to transfer their headquarters to another member State, or to establish affiliates there, without being obliged to adapt their corporate structures in the host country to the latter's legislation. This has clearly been rejected by the European Court of Justice in its *Daily Mail* decision.[28] The investment is, in principle, subject to the rules of establishment existing in the host country.

However, there has been a European Community proposal in the area of conflict of laws concerning the mutual recognition of companies. This draft directive[29] introduces common standards concerning the recognition in general of companies located in another member State, without dealing with establishment issues in the host country. However, this directive never became effective.

From the existing European Union directives on company law, it seems that only directive 89/666/EC of 21 December 1989[30] concerning disclosure requirements in respect of branches opened in a member State makes a distinction between European Union and non-European Union investors: non-European Union investors that intend to open a branch in a member State have more obligations to fulfill concerning publicity and information requirements with respect to that branch than their European Union competitors. The reason for this different treatment is that the parent company in the home country is likewise

[27] European Court of Justice, Case 120/78 (1979), E.C.R. 649 (Cassis de Dijon).

[28] European Court of Justice, Case 81/87 (1988), E.C.R. 5483.

[29] The Agreement was signed on 28 February 1968 (see the Official German Law Gazette 1972 II 270).

[30] Official Journal Legislation (OJ L) 395, 30 December 1989, p. 36.

subject to information duties so that not all of the information already provided by the parent company has to be given once more by the branch. Conversely, a parent company in a non-European Union member State does not have to fulfill these requirements because Union law does not apply. It is therefore justified that the branch of such an investor in the Union has to make up for the lacking information. A different treatment between Union and non-Union investors is necessary unless the respective third country provides with similar information about the parent company.

Sectoral regulations

It is not possible within the limits of this article to examine all sectoral European Union legislation concerning FDI. Three industries shall suffice: banking, insurance and transportation. European Union secondary legislation in these areas at least partially reflects the same concepts as they were mentioned above with regard to company law.

- *Banking*

European Union legislation in this area has focused on the harmonization of existing standards for the control of financial institutions and the protection of shareholders. Furthermore, the relevant directives stipulate that, based on such harmonized rules, the control of such financial institutions mainly takes place in the respective home country (Fetzer, 1992, p. 9)

From the various directives adopted so far, at least four contain rules that distinguish between European Union and non-European Union investors:

—Directive 89/117/EC of 13 February 1989[31] deals with the obligations of bank branches to publish annual accounting documents when the branch and the parent company are located in different countries. According to Article 2 para. 3, branches of European Union banks are not obliged to produce an annual report with regard to their own financial operations; it is sufficient to refer to the respective statements in the parent companies' report. Conversely, the

[31] OJ L 044, 16 February 1989, p. 40.

branches of non-European Union banks can be required to present their own annual report (Article 3, para. 3). Only in the case that the relevant information provided by the parent company is in accordance with European Union legislation, and under the condition that European Union branches receive reciprocal treatment in the respective third country, are branches from non-European Union investors exempted from this requirement (Article 3, para. 2).

—Directive 77/780/EC of 12 December 1977[32] deals with the co-ordination of the laws of the member States relating to the taking up and the pursuit of the business of credit institutions. According to Article 9, para. 3, the Union is authorized to negotiate bilateral treaties with third countries that would grant credit institutions of third countries the same rights concerning the establishment in the Union than European Union banks have, provided that the principle of reciprocity is respected.

—The before-mentioned directive has been amended by directive 89/646/EC of 15 December 1989.[33] This directive abolishes the requirement for branches to get a permission in order to operate in a member State if the parent company has already received such a permission in the home country member State. According to Article 9, paras. 3, 4, member States are allowed to deny branches from non-European Union investors the same rights if, vice versa, European Union branches in the respective third country do not have effective market access comparable to the one the Union provides.

—Directive 83/350/EC of 13 June 1983[34] deals with the supervision of credit institutions on a consolidated basis. Article 6 provides that, with regard to third countries, such supervision should be governed by bilateral treaties based on the principle of reciprocity.

- *Insurance*

In the area of insurance, there are at least five directives that distinguish between European Union and non-European Union investors:

[32] OJ L 322, 17 December 1977, p. 30.
[33] OJ L 386, 30 December 1989, p. 1.
[34] OJ L 193, 18 July 1983, p. 18.

—Directive 79/267/EC of 5 March 1979[35] deals with the coordination of the laws of the member States relating to the taking up and the pursuit of the business of direct life assurance. Contrary to branches of European Union insurance companies, branches of non-European Union investors do not have a right of establishment, although investment is, on the other hand, not prohibited (Article 27, para. 2). Furthermore, according to Article 32, the Union is entitled to conclude bilateral treaties with third countries in which it can deviate from the provisions of the directive in order to guarantee a sufficient protection of the insured individuals on the basis of reciprocity.

—This directive was first amended by directive 90/619/EC of 8 November 1990.[36] It provides for the possibility that affiliates of non-European Union investors do not get access to the Union if the European Union companies do not have comparable effective market access in the third country (Article 9).

—Directives 79/267/EC and 90/619/EC were amended by directive 92/96/EC of 10 November 1992.[37] According to its Article 4, the permission to do business that an insurance company receives in one member State extends to all its operations in the Union. Therefore, there is no additional permission requirement if the company opens a branch in another member State (Article 32).

—Directive 73/239/EC of 24 July 1973[38] deals with the coordination of the laws of the member States relating to the taking up and the pursuit of the business of direct insurance other than life assurance. It contains provisions similar to those in directive 79/267/EC with regard to life assurance.

—This directive was amended by directive 88/357/EC of 22 June 1988,[39] and directive 92/49/EC of 18 June 1992.[40] According to Article 5 of the latter, the admission of a direct insurance company in one member State is once again valid for the whole Union. Thus,

[35] OJ L 063, 13 March 1979, p. 1
[36] OJ L 330, 29 November 1990, p. 50.
[37] OJ L 360, 9 December 1992, p. 1.
[38] OJ L 228, 16 August 1973, p. 3.
[39] OJ L 172, 4 July 1988, p. 1.
[40] OJ L 228, 11 August 1992, p. 1.

if this company wishes to open a branch in another member State, an additional permission is no longer necessary (Article 32).

- *Transportation*

Of particular importance in the present context is regulation No. 2407/92 of 23 July 1992[41] concerning the issue of operation licences to air carriers. According to Article 4, para. 2, investors from non-European Union member States are, in general, not allowed to own more than 49 per cent of the shares of an air transportation company in the Union. A similar provision exists with regard to maritime transport. According to Article 2.2 of regulation 3577/92 of 7 December 1992,[42] applying the principle of freedom to provide services to maritime transport within member States, a shipping company is only allowed to provide cabotage services if the enterprise is at least 50 per cent owned by European Union nationals.

Capital movement

The most important act in this area is directive 88/361/EC of 8 July 1988.[43] Article 7, para. 2 gives member States the right to intervene in capital movements with regard to third countries if short-term movements of a considerable amount seriously threaten the internal or external monetary or financial situation in the respective State. However, this situation could be covered by general provisions concerning the transfer of capital, and does therefore not require a REIO clause.

Taxation

Directive 90/435/EC of 23 July 1990[44] provides for a common tax system with regard to parent companies and affiliates located in different European Union member States. There exists also an European Community Agreement concerning the avoidance of double taxation in case of profit corrections between connected enterprises (Agreement No. 90/346/EC of 23 June 1990[45]). Although these regulations do not

[41] OJ L 240, 24 August 1992, p. 1.
[42] OJ L 364, 12 December 1992, p. 7.
[43] OJ L 178, 8 July 1988, p. 5.
[44] OJ L 225, 20 August 1990, p. 6.
[45] OJ L 225, 20 August 1990, p. 10.

contain specific provisions in respect of non-members, there is an implicit discrimination against non-European Union investors because only companies located in member States can benefit from tax alleviations contained therein.

Conclusions

To what extent does this secondary legislation call for a REIO clause? With regard to a possible justification of discrimination against non-European Union investors, at least four categories of European Community regulations and directives can be distinguished:

- First, there are acts that discriminate against non-European Union investors because investment liberalization is based on the concept of mutual recognition to which non-members do not adhere.[46] In all these cases, European Union investors receive certain benefits in the host country that derive from the fact that member States mutually recognize certain facts and laws with regard to the parent company located in another member State. For example, the regulation that branches are not required to provide information concerning such issues that have already been published by the parent company could not be unilaterally extended to European Union outsiders because the Union has no guarantee that non-Union parent companies provide information to the same extent. The same holds true for the provision that branches of banks and insurance companies do not need a separate permission to operate in a member State provided that the parent company has already received such a permission in the member State where it is located. Parent companies outside the Union could not receive the same benefits as long as they do not fulfill the requirements for a permission as laid down in the relevant secondary legislation—requirements they cannot be forced to respect because European Union law does not apply to them. In all these situations a different treatment between European Union and non-European Union investors is justified as long as the respective third country does not undertake the same obligations *vis-à-vis* the European Union and its member States.

[46] Company directive 89/666/EC, banking directives 89/117/EC, 89/646/EC, and 83/350/EC, insurance directives 79/267/EC, 92/96/EC, 73/239/EC, and 92/49/EC.

Another category of European Union internal liberalization based on the concept of mutual recognition relates to diplomas. However, in the present context such measures would be confined to natural persons acting as investors. The non-extension of benefits deriving from mutual recognition would be justified because this concept presupposes that the countries concerned have agreed upon some common standards as the basis for recognition. This provides an answer to the question whether natural persons being investors (and that do not have the nationality of a European Union member State) should receive treatment as provided under Article 52 European Community Treaty: at least in situations where the mutual recognition of diplomas is at stake, the non-discrimination principle could not automatically apply.

This leads to the question whether such differentiation would already be covered by the suggestion according to which MFN treatment for non-European Union investors cannot go beyond national treatment. The answer depends on whether the concept of mutual recognition is considered as something that exceeds national treatment or not.

Interpreted in a narrow way, national treatment means that, irrespective of the nationality of the investor, the same investment rules apply. In this perspective, mutual recognition is more than national treatment because it may exempt foreign investors from fulfilling certain legal requirements in the host country. On the other hand, it may be argued that the concept of mutual recognition only intends to place foreign investors on an equal footing with their domestic competitors, without giving them better treatment than the one reseved to domestic investors. Understood in this way, mutual recognition would be a special kind of national treatment.

No matter whether national treatment encompasses the concept of mutual recognition or not, non-European Union investors cannot claim MFN treatment in this respect. To avoid any doubts, the issue of mutual recognition should be dealt with in a REIO clause separately. Thus, the clause would have to exclude non-European Union investors from MFN treatment that is better than national treatment or which would result in a treatment that is based on the concept of mutual recognition.

- Second, there are regulations that—either alone or in combination with the concept of mutual recognition—introduce the principle of reciprocity. Whereas the concept of mutual recognition means a certain legal technique based on the existence of harmonized ground rules, reciprocity has a much vaguer scope. There is no objection against the latter as long as it simply reflects the idea that an agreement should lead to a fair balance of commitments between the contracting parties. However, insofar as the principle of reciprocity means that investment conditions have to be more or less identical before a foreign investor can be admitted, it can only be seen with suspicion. In this respect, in particular directives 89/646/EC and 90/619/EC contain provisions that would be difficult to justify under a REIO perspective. The mere fact that European Union investors do not have the same market access to a third country than vice versa is not sufficient to exclude non-European Union investors from Union treatment. Therefore, in general, a reciprocity requirement could not be covered by a REIO clause, although a careful analysis concerning the concrete implication and scope of the reciprocity requirement concerned is necessary in each individual case.

- Third, there are rules dealing with taxation, such as directive 90/435/EC and the Agreement 90/436/EC. In these accords, the European Union partners grant each other certain tax exemptions and privileges. It is generally recognized that such benefits are granted on a mutual basis, and that therefore the MFN principle does not apply with regard to tax agreements. As this is a general rule, there is no need to cover special tax treatment within the European Union by a REIO clause.

- Finally, there are rules that prohibit investments from non-European Union investors altogether or which introduce certain ceilings for capital participation. For example, this is the case in regulation 2407/92/EC. It is obvious that the case for a REIO clause is the weakest here. Such restrictions are not required by the special nature of the integration arrangement as such, but could be applied by any country.

Possible content of a REIO clause

How could a REIO clause read? The examination of the European Community Treaty and European Union secondary legislation has shown that the Union would need such a clause where, otherwise, MFN treatment would result (*a*) in a better treatment than national treatment, or (*b*) would introduce the principles of precedence and direct applicability of European

Union law to non-European Union investors, or (*c*) where the treatment of a foreign investor is based on the concept of mutual recognition. However, this reflects only the present legal situation in the European Union. It can not be excluded that, in the future, new concepts will be developed in order to further enhance internal liberalization, similar to what has already happened in the past. Although it is hard to imagine what else could be done beyond the principle of mutual recognition, one simply does not know what the future will bring. It therefore seems necessary to keep the REIO clause open for such possible future developments. On the other hand, this must not result in an escape-clause which would give a regional economic integration organization the right to introduce future discrimination at will. It would therefore not be appropriate to grant this right with regard to all future internal investment liberalization measures in general. Rather, there must be substantive reason why this liberalization cannot be extended to European Union outsiders. Thus, a REIO exception should only be allowed if the concrete method through which liberalization is achieved requires European Union membership.

This article has only dealt with the special situation of the European Union. The conclusions drawn can, therefore, not automatically apply to any other regional economic integration organization as well. However, it seems likely that any other organization of this kind would use similar concepts with regard to investment liberalization as the European Union—simply because there are no other legal techniques in sight. If this holds true, then the lessons learned from the European Union would be of general applicability. ■

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