Trade and foreign direct investment policies: pieces of a new strategic approach to development?

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In recent years there has been a fundamental rethinking of development strategies. This re-examination has many and complex ramifications and causes. This article is concerned mainly with trade and foreign direct investment (FDI). In the trade-policy field, a large and growing number of developing countries have introduced or are introducing liberalization programmes that include the total or partial dismantling of non-tariff measures and reductions in the levels and dispersion of tariffs. As regards FDI policies, these have also undergone substantial change. From a distrust of transnational corporations (TNCs) and an approach that relied mostly on a host of restrictions and prohibitions, Governments in developing countries are now coming to appreciate what foreign investors can contribute to development. As a consequence, policies in this field have also been substantially liberalized, and many countries are in outright competition with each other to attract FDI.

A joint strategic trade and foreign direct investment policy approach

The case for an organic policy approach

The new approach to development arises not simply from a conversion to liberal ideals, although a greater appreciation of the limits of Government and the possibilities offered by markets certainly has played a role. The main factor behind this sea-change in attitudes is the realization by policy makers that development, in today's world economy, implies attaining international competitiveness in a growing number of industries. This new approach reflects itself in a growing emphasis on exports as an engine of growth and on technological transformation in the domestic economy. Pure import substitution at any cost is a thing of the past.

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This rethinking of development strategies arises out of the trends that can be observed in the international economy and, in turn, contributes to it. These trends are well described by the term "globalization", which can be characterized by four stylized facts:

- International trade in both goods and services is growing faster than domestic output in most countries and certainly in the world economy as a whole.
- Foreign direct investment is growing faster than national investment.
- International financial flows are growing at a much faster rate than domestic financial transactions.
- International trade, investment and finance are all occurring at the same time and through the same agent, the transnational corporation.[1]

Globalization has direct implications for both the activities of TNCs in developing countries and the objectives that Governments of developing countries have in seeking to attract them. Whereas in the early post-war period, the wave of FDI into (mostly) Europe and Latin America was oriented fundamentally to domestic markets, over the past decade or so, the motivation for FDI in developing countries has slowly shifted from producing for the domestic market to using the host economy to manufacture a part or component of a product for world or regional markets. This is partly because production and distribution are increasingly being carried out within world-wide, and increasingly complex, networks of firms (UNCTAD, 1993). Therefore, except for the largest host countries, the objective of penetrating the markets of individual nation states has taken a backseat to planning for global or regional markets.

It also is related to the changes in development strategies, to which mention has already been made. As development strategies have shifted from import substitution to export orientation, trade barriers have come down, enabling TNCs to consider the advantages offered by a growing number of sites in the developing countries. In T. Ozawa's (1992) terminology, the shift from an inward-oriented import-substituting strategy to an outward-oriented export-promoting one fosters comparative-advantage advancing FDI, which comes to replace FDI in industries in which a developing country has comparative disadvantages. By eventually bidding up wages, this very process tends to erode eventually the labour-cost

[1]The growing importance of transnational banks in the world economy is a special case of the more general phenomenon of the ascendancy of the TNC.

advantages host countries have, gradually transforming them into foreign investors in lower-wage economies.

These stylized facts fit well the situation that one finds in the economies of East and South Asia, which are well on the way to constituting a closely knit regional grouping forged through trade and FDI links. It also describes recent developments in Mexico, as it becomes more integrated economically with North America. In this case, the close economic links already existing between Mexico and the United States will be intensified with the coming into effect of NAFTA.[2] The reforms undertaken by other Latin American countries may eventually push them into a similar relationship with each other. Not only are trade barriers rapidly coming down in most countries, but a number of bilateral and plurilateral free trade agreements have been signed between them in the 1990s, and this process is likely to accelerate. The eventual extension of NAFTA southward would also stimulate hemispheric economic integration. Moreover, the lowering of barriers towards FDI has attracted considerable flows to some of the countries of the region, particularly Argentina, Brazil, Chile, Mexico and Venezuela (Calderón, 1993). Trade agreements in the hemisphere would accelerate the trend towards larger FDI flows of recent years.

However, most parts of the developing world have yet to be incorporated into the globalization or regionalization processes. This may be due to a variety of factors, including the incipient stage of their economic reforms and the possession of few assets of interest to TNCs.

As regards an individual developing country wishing to attract FDI, the new strategy of TNCs involves an increasing export orientation of their activities. It also implies that FDI is considerably more footloose, that TNCs view increasingly individual countries as alternative sites and that FDI is becoming more difficult to attract and to keep. If, indeed, TNCs are in process of changing their investment strategies and are "going more global", this would mean that trade policies of potential host countries will become increasingly important in efforts to attract and keep FDI.

While the benefits of international competitiveness in a growing range of activities has come to be recognized as a key ingredient for development, what is less appreciated is the need to develop an integrated approach to development policy. In particular, globalization is clearly pointing to the need to consider trade and FDI policy jointly. This article argues in favour of a *joint strategic trade and*

[2]Mexico's trade with the United States accounts for over two thirds of its total trade, and United States-based TNCs are Mexico's main foreign investors.

FDI policy package. A pure trade policy ignoring other areas (in the case of this article, FDI) is clearly suboptimal in a world in which TNCs are among the principal producing and trading agents.

Lessons from the new trade and growth theories

The case for selective trade policies has been well rehearsed. Left to its own devices, the market is particularly inefficient in identifying long-term, potential comparative advantage, which, in J. Dunning's (1992) apt characterization, depends on increasing the ratio of created assets to natural assets. This is especially so in the developing world, where the private sector and market institutions are weak. Under these conditions, there is an important role for government intervention in identifying industries with long-run promise, steering investment resources in their direction, acting to complete or create markets and investing in the creation of complementary assets in which the private sector is likely to under-invest (because of the public-good nature of those assets). This will involve, *inter alia*, both trade and FDI policies.

The new trade theories (Krugman, 1987 and 1990; and Ocampo, 1991) stress the characteristics of modern economies that violate the assumptions needed for incentive neutrality to be the optimal trade policy. The most relevant notions for developing countries derived from the new theories are those related to learning effects, economies of scale and external economies. In fact, the validity of the concept used above—that of potential, or acquired, comparative advantage—depends on the existence of at least one of these phenomena. Comparative advantage can be acquired if an activity has learning effects, that is, if costs decline as workers and managers become more familiar with new technologies, management or marketing methods. Or, in the case of economies of scale, average costs decline as the scale of production rises, permitting firms to become internationally competitive. Externalities are particularly relevant to developing countries because the social benefits of acquiring any new technology, management method or marketing expertise are likely to be much higher than the private benefits. And private costs are unlikely to be recouped by individual firms investing in these activities. New production or marketing methods spread from innovating firms to other firms in a variety of ways, including franchising and licensing, the migration of labour and management, imitative behaviour, or through supplier/purchaser relationships. Therefore, spillover effects can help a whole segment of an economy to *acquire* comparative advantage.

At the same time, the new endogenous growth literature has stressed the importance of investment in human capital and in the stock of knowledge as determinants of growth (Romer, 1990 and 1993). In this conceptual framework, the most important contribution that FDI can make to the economic growth of host developing economies is not in the form of capital; rather, it can relax the key constraint of knowledge with an economic value (what can loosely be identified with technology). An economy that is closed to FDI deprives itself of ideas that are the proprietary knowledge of TNCs and which, because of the economic value of exploiting these assets internally, TNCs are unwilling to license or sell at arm's length. As recently stated in UNCTAD (1993, chapter XI), "... given international knowledge spillovers, it is more important to host technology than to own it". By contrast, an economy with liberal policies towards TNCs will be able to take advantage of a stock of knowledge that is vastly superior to that available to its own productive factors. And, as already noted, given the "non-rival" nature and difficult appropriability of technology (and of any idea), the siting in a host developing country of foreign firms may have large and positive spillover effects. Therefore, policies that are favourable to FDI and other activities of TNCs are more likely to lead to a transfer of technologies and knowledge to host countries than policies that put undue emphasis on domestic control over productive activities. Indigenous capabilities are more likely to be developed through welcoming than through restrictive FDI policies.

However, this does not mean that no effort should be made to steer FDI into particular sectors or to influence the activities that they carry out in a host economy. As an economy moves from dependence on natural resources as its basis of comparative advantage to a greater dependence on *created* assets, TNCs can play a major role *and can be deliberately encouraged to do so* by specific government action.

One of the policy implication that has been emphasized in the literature on the new trade theories is that there is ample scope for government intervention in trade in order to maximize developmental impacts. It has not been equally stressed that there are as well important FDI policy implications, nor that, in the context of globalization, strategic trade and FDI policies need to be considered jointly. This article emphasizes two policy implications of the new trade and growth theories that are germane to the issue of the complex of trade and FDI policies. One has already been discussed: the identification of sectors in which a country can reasonably expect to acquire comparative advantage and the promotion of production in such sectors. The other is the promotion of activities with large externalities for the rest of the economy. This will normally involve not only domestic investment, but also—and in some cases primarily—FDI and other forms of TNC activities.

The question arises as to what are the best methods to pursue selective intervention in an economy. According to J. Bhagwati (1988, pp. 98-100), the successful Far Eastern export-oriented economies managed their policy interventions and strategic decision making through *prescriptive* rather than *proscriptive* methods. Under proscriptive regimes, activities that are not specifically permitted tend to be prohibited. Thus, for example, such regimes typically make heavy use of licensing (e.g., for imports or domestic and foreign investment) and rely on high and differentiated tariffs. By contrast, the use of quantitative controls and prohibitions is much less widespread under the prescriptive approach, which instead tends to rely more on incentives (particularly production, export or interest-rate subsidies) and on moral suasion.

This distinction is even more germane to FDI policy than to trade policy: if the argument is correct that open FDI policies are more conducive to the development of indigenous capabilities than restrictive policies, the most successful approaches to FDI policy will be those that emphasize incentives to do the "right" things and undertake desired activities, rather than prohibitions or limitations on activities perceived to be undesirable, which tend to discourage *all* investment.

The development of an integrated policy package

The linkage between trade and foreign direct investment

If countries are to succeed in changing the manner in which they participate in the international economy, it is important that the linkages between trade and FDI be recognized explicitly. Trade policy has *always* affected FDI flows. In fact, there is a little understood interaction between the way that TNCs tend to look at the international economy and the trade policies in vogue in developing countries. In the post-war period, up to the 1980s, TNCs tended to view national markets as discreet, and their investment decisions in one market were connected to those made in another only by the overall constraints of their managerial or financial resources and not by the integration of production decisions on a global or regional basis. Developing country Governments tended to foster this attitude through trade policies that favoured import substitution and market-seeking FDI. In turn, the trade policies of developing countries were inward-looking partly because policies of import substitution produced results in terms of attracting FDI.[3]

In more recent years, a gradual shift in the strategies of TNCs has taken place (UNCTAD, 1993). Transnational corporations themselves have grown into international networks of firms producing for world or regional markets. Thus, FDI

[3]There were of course many other reasons, including deteriorating terms of trade for primary commodity exporters and the prevailing approaches to economic development and industrialization generally.

decisions in one country have become more organically linked to FDI decisions in other locations within a network. Accordingly, FDI in developing countries of the labour-seeking or component-sourcing variety has gained in importance.[4] As a consequence of this trend and contributing to it, trade policies in developing countries have been considerably liberalized.

Under current circumstances, TNCs are likely to be interested not only in a liberal FDI policy (a necessary but not sufficient condition for investment) but in whether a country is suitable for inclusion in their networks. It is in this sense that trade policies acquire particular relevance. Policies for attracting TNCs that are regionally or globally oriented are likely to include the establishment of well-functioning export-processing zones, the availability of facilities such as effective and administratively easy-to-use tariff-drawback schemes for foreign inputs going into production for export and a stable exchange rate that is favourable to the production of tradables (and, therefore, encourages the sourcing in the country of value-added activities oriented to foreign markets).

It is becoming increasingly understood that liberal policies *per se* will not necessarily yield outward-oriented development, and that more pro-active and organically linked trade, investment and industrial policies are necessary. And export-oriented trade policies can be significantly enhanced by linkages to TNCs with access to markets and whose networks themselves constitute channels to international markets. It is often difficult to obtain access to international markets outside the channels of TNCs, both because international markets are intrinsically difficult to penetrate (for example, information on consumer tastes or specifications may be difficult to obtain, national firms may not produce goods of desired quality) and because trade barriers tend to discriminate against national firms from exporting countries and in favour of foreign affiliates of home-country TNCs.

Moreover, the blending of suitable trade policies with investment policies (of which FDI policies are a subset) is more likely to yield results than export-promoting trade policies just by themselves. Investment policies are needed to overcome the scarcity of competitiveness-enhancing assets, with export-promoting trade policies playing a supportive role. Finally, the trend in international trade negotiations at both the multilateral and regional levels is towards the placement of increasing restrictions on the ability of Governments to subsidize their

[4]This does not mean that FDI for domestic markets has disappeared. The countries with large markets (Brazil and India, for example) can still expect to be attractive for market-seeking investment, if policies towards FDI are favourable and other conditions are met. In other cases, resource-seeking investment in developing countries could remain the most important kind.

exports, even when those exports represent a small share of world markets (Agosin and Tussie, 1993). This means that the way to go is through stimulating investment in sectors in which countries can acquire comparative advantage, and FDI policy has a clear role to play in this context.

Towards a new policy paradigm?

Traditionally, foreign trade was considered to be the main link between the domestic and the international economies. As a result, policy makers, in their efforts to improve the integration of their countries into the international economy, were mainly concerned with the consistency of trade policy and its desired impact on trade flows. With the growing importance of TNCs as agents for gaining access to international markets and technologies, issues relating to FDI and how to attract it have gained in prominence. New instruments, norms and regulations have become far more relevant to such "deep integration" than the traditional "border measures" (Lawrence, 1993). The new policy mix requires a far more complex set of instruments than the traditional discussion of tariffs and non-tariffs measures *cum* exchange rate policy. For developing countries, the challenge is to devise an integrated policy package aimed at achieving a more dynamic insertion into the world economy.

Although it would be senseless to attempt to design a "generic" package that could fit all countries and all their particular needs, it is certainly possible to identify some key concepts that have been brought to the centre of international discussions under a new light and that might help one to develop a new conceptual framework for the planning, implementation and evaluation of economic policy in an integrated fashion.

Three major principles of international economic relationships have been redefined in the effort of the world community to strengthen economic interdependence and promote world economic growth. These principles are most-favoured-nation (MFN) treatment, enhanced market access and national treatment. Although these principles have for long been recognized as the basis of merchandise trade relationships, in recent years they have taken on new dimensions, and an effort has been made to extrapolate them to other realms of international policy making and to transform them into the cornerstones for a deep integration of the world economy. An example of these new goals can be found in the multilateral negotiations that are taking place in the Uruguay Round, especially in the areas of services, intellectual property rights and trade-related investment measures.

A fourth category of measures that needs to be taken into account in the design of a trade-FDI policy package are measures to enhance international competitiveness. These measures do not fit easily into the other categories and have become the subject of intense trade disputes in the past. They also go well beyond the border measures of concern to traditional trade policy.

The first three principles being discussed have, for long, constituted a desirable goal of international economic negotiations in the area of merchandise trade. Few countries, if any, do actually conform completely to each and every one of these principles. Most countries have chosen to depart partially from them in order to allow for certain discretionalities in the handling of their own economies. Such departures are, in some cases, an answer to domestic political pressures or, in others, the result of differing perceptions of how to attain given developmental goals. In fact, the careful choice of such departures should be the key to a development strategy that is selective in its approach and integrates trade and FDI elements.

Most-favoured-nation treatment

This principle is at the heart of multilateralism and constitutes the cornerstone of the GATT. The purpose of the MFN clause is to eliminate all sources of discrimination in the treatment granted by one individual country to the rest of its trading partners. Its scope of application was—up to now—limited to merchandise trade and basically to the application of tariff barriers. In spite of many declarations of adherence to this clause, reality shows that countries do in fact discriminate in their trade relations with different countries. Generalized systems of preference (GSP) schemes, preferential trade agreements, trade zones, economic unions and a number of special arrangements do in fact violate the MFN commitment. Departures from this key principle are normally justified whether with the argument of compensating the asymmetries prevailing among different countries (like in the case of GSP schemes), on the basis of economic, cultural, political or geographical affinities (the case of the European Community), or to promote faster rates of liberalization among "similarly minded" countries (the case for NAFTA).

But the commitment to MFN treatment rarely went beyond covering some border measures affecting merchandise trade. As regards the international movement of factors of production and other non-border issues, substantial discrimination in the treatment granted to different countries is the rule. Wide use is made of bilateral or otherwise limited fiscal agreements of a discriminatory nature (for example, double taxation treaties). Also, many countries have signed bilateral investment agreements, and many special cooperation agreements cover discriminatory arrangements in the fields of labour mobility and harmonization and the recognition of professional services. Moreover, a number of preferential schemes exist for the transfer and use of technology, access to government procurement, the use of subsidies, access to credit and foreign exchange and the implementation of just about every possible economic instrument, norm or regulation pertaining to economic activities. The internationalization of areas as diverse as banking, insurance, medical services, agricultural production, the automobile industry, entertainment and cultural activities, computers, maritime, air and road transportation and so on, are all affected at various levels by a complex network of special international arrangements. *Reciprocity* rather than *non-discrimination* seems to be the rule in the handling of international economic relations in matters that go beyond the border measures that affect merchandise trade.

The recognition of this fact gives us a clue as to the first critical question in the design of an integrated package or policy mix, and this is: what is the size and location of the particular economic space in which an individual country wishes to evolve? Obviously, there will not be a single economic space that suits the needs of all countries, independently of how much political will there is in a given country to promote multilateralism at a world scale. The definition of such a space will have to take into account a number of relevant considerations, such as the geographical location of the country in question; its relative stage of development; its technological, capital, physical and human resource endowment; the identification of its "revealed" comparative advantages, as well as those the country wishes and is able to create; and its social, cultural and political specificities. The selection of the individual countries that may constitute such a space will look closely into the degree of complementarity that may be generated through preferential arrangements with those potential associates. In other words, as much as entrepreneurs follow discretionary and highly selective approaches when seeking new partners to develop their projects, countries need to follow a similar strategy in the definition of the economic space in which they wish to interact so as to maximize the development impact of such integration.

It is interesting that most new bilateral or plurilateral free trade agreements that have been signed in the recent past (or are actively under negotiation) include investment provisions. This is as true of the Canada-United States Free Trade Agreement, as of NAFTA or the agreements that are being signed in Latin America (e.g., MERCOSUR or the Chile-Mexico agreement signed in 1991). The high degree of trade integration achieved between Japan and the newly industrializing economies of South and East Asia, rather than being promoted by formal government integration efforts, owes more to market forces and to FDI decisions, first by Japanese corporations and more recently by those of the more industrialized developing economies of the region; however, the specific encouragement of Governments has also played an important role (Ozawa, 1992; UNTCMD, 1992). For example, the Government of Japan has aided the process of internationalization of Japanese corporations by providing financing to developing countries in the region for the construction of complementary infrastructure.

Recent evidence indicates that integration policies at the trade level can play a great role in stimulating FDI. In the case of Mexico, the recent huge increase in FDI owes a great deal to NAFTA. It seems that corporations are beginning to see Mexico as part of North America and are in the process expanding into Mexico as a way of penetrating the North American market. It is also true that, without the reassessment of FDI policies that Mexico has undertaken since the mid-1980s, it would not have been possible for the country to take advantage of the many opportunities that the NAFTA will eventually open (UNCTC, 1992). Mexico has followed a two-pronged approach: on the one hand, it has sought greater economic integration into the North American market and, on the other, it has very significantly liberalized its trade and FDI policies towards the world. Both approaches are supportive of each other.

A similar strategy may be in the making in the rest of Latin America. Most countries in the area have removed barriers to trade and FDI (some more successfully than others). At the same time, Argentina, Brazil, Paraguay and Uruguay have moved towards forming a common market (MERCOSUR), and there has been a spate of free trade.agreements between different countries in the region (Lahera, 1992). Several countries, in particular Chile, have expressed their enthusiasm for a free trade agreement with the United States. The basic objective behind these movements is not primarily that of reaping the static gains from customs unions emphasized in the trade literature. Rather, it is hoped that the creation of larger economic spaces (most of them regional), in the context of generally liberal trade and FDI policies, would encourage a substantially enlarged flow of FDI for regional markets.

Market access

It is obvious that very little would be achieved in the area of world economic interdependence with the mere application of the MFN principle on a world scale if all countries decided to deny market access on a non-discriminatory basis. Domestic economies would remain closed and the benefits of international trade would fail to accrue to the world community. But once again, this principle is far from being a general rule, even in the area of merchandise trade, for most countries. Although tariff barriers have declined over the years, a number of non-tariff barriers and so-called "grey-area" measures such as voluntary export restraints and orderly marketing agreements have proliferated almost *pari passu* with declining tariffs.

The concept of market access has been limited, up to now, to the removal of border measures that would facilitate the cross-border flow of goods at the international level. The deepening of economic interdependence would require the removal of all internal measures that discriminate against the provision of goods and services by foreign suppliers, *even when permanent establishment in the domestic market* is required by such suppliers. On the other hand, certain temporary limits to market access might be beneficial for the country imposing them, if such limits assist it in developing new capabilities in industries subject to strong learning effects or with important externalities for the rest of the economy.

Generally, the smaller the domestic market of a country, the more important will be the market access it is granted by others. For example, access to the European Community for clothing has been a fundamental factor in determining the location of foreign firms in Mauritius' export processing zones. Likewise, as already noted, the negotiation of a free trade agreement or a common market among a group of countries will make all the participating countries more attractive to TNCs.

Certain market-access decisions in services may also have important trade effects that need to be considered. Two competing considerations need to be taken into account in deciding the extent of market access in services that a countries wishes to offer foreigners. On the one hand, market access can be curtailed in services such as banking and insurance in order to provide domestic suppliers a "breathing space" to become competitive. On the other, policy makers need to be aware of the fact that the competitiveness of goods may be crucially affected by the availability of low-cost, high-quality producer services (such as telecommunications), which TNCs are frequently better equipped to provide than national firms. In some cases, the entry of TNCs may render domestic markets more competitive and lower unit costs. Likewise, locational decision by goods-producing TNCs may depend on the availability of low-cost producer services. Some of these considerations have been important in recent privatizations and the opening up to foreign investors of utilities, telecommunications and financial services industries in several countries in Latin America.

The decision will depend on the economic development strategy of individual countries. In this respect, the critical question is: in which industry can a country expect to develop international competitiveness in a reasonable period of time? In other words, where does dynamic comparative advantage lie and how can policies towards FDI in services contribute to it?

The notion of market access is relevant to other measures as well. Some of these are directly related to TNC activities. Examples of market-access measures in the broad sense are restrictions on FDI or on foreign equity participation, restrictions on the movement of personnel, limitations on market shares for foreign companies and conditionality for the acquisition or transfer of technology and know-how. As can be adduced by the line of argument developed in the first part of this article, fairly broad market access is more desirable.[5]

National treatment

The application of full national treatment represents the ultimate stage of world economic integration. An old aspiration of merchandise trade agreements, it has been substantially realized in the area of cross-border goods trade. The application of full national treatment to foreign capital, labour, technology and services presents a far more complex case. The basic issue relating to the concept of national treatment is that policy makers need to be conscious of the ways in which their decisions affect the treatment that foreign goods, services, corporations or persons receive and the objectives that any departure from national treatment pursues. As a general principle, national treatment ought to be the rule. But in selected circumstances, it may be necessary to bar foreign firms from benefits open to national ones (because national firms are at a "structural" disadvantage) or to offer them benefits to which nationals do not have access (in cases in which foreign corporations clearly provide assets that are particularly scarce in the national economy). In some cases, it may be appropriate to mix both approaches.

There are a number of policy instruments that affect the operations of companies located within a country and that can be applied using three criteria: discriminatory treatment in favour of domestically owned companies; full national treatment; and treatment more favourable to foreign owned companies. The instruments involve, among others, procedures for the collection of taxes, tax rates, access to domestic and foreign credit, access to subsidies and tariff-drawback schemes, access to government procurement, price intervention, research and development subsidies and subsidized interest rates for certain activities. As already noted, in today's economic environment, national treatment for foreign producers in the area of access to competitiveness-enhancing measures (export or training subsidies, tariff-drawback schemes) is likely to be an important determinant of TNCs' locational decisions.

Competitiveness-enhancing measures

This category relates mainly to those measures that seek to improve an economy's international competitiveness. In the first place, there are subsidies of

[5]Market regulation, for prudential and other reasons, is, of course, essential.

various types, not only to exports but to production, labour training or technological upgrading. Government spending or subsidies to private spending on particular kinds of education, the building of infrastructure needed to export, the provision of producer services of various types (in particular, telecommunications) and efforts to improve the operation of domestic capital and credit markets are also part of such policies. The locational decisions of TNCs are likely to be increasingly affected by policies of this nature (in particular, export processing zones and administratively simple tariff-drawback schemes) than by the existence of protected national markets.

It should be kept in mind that such policies, if they are to be successful, should be highly selective (in the sense of few in number). Government failure is as prevalent in developing countries as market failure: the capabilities of effective action by Governments are severely limited; and, as pointed out by many analysts (e.g., Bhagwati, 1982; Krueger, 1974), policies that seek to skew market prices lend themselves to abuse and unproductive rent-seeking. The avoidance of rent-seeking can be ensured by tying all incentives to the delivery of specific performances, as the East Asian newly-industrializing economies have successfully done.[6]

It should also be noted that competitiveness-enhancing measures are not synonymous with a policy of "picking the winners". The latter is open to the criticism that policy makers are less likely than the private sector to know which are the activities with potential comparative advantage, and that mistakes can be particularly costly.[7] Competitiveness-enhancing measures can apply to broad types of activity (non-traditional exports, research and development expenditures, training of local staff), and can be written into tax laws and regulations that are automatic and non-discretionary. In other words, they could take the form of a "performance based tax system" for business income. What is no longer at issue is the need for a competitiveness strategy and its operationalization through appropriate policies. As Dunning (1992, p. 8) observes:

> "Any Government that . . . pursues a 'hands-off' or 'leave-it-to-the-market' strategy is likely to be as negligent in promoting the welfare of its citizens, as were its predecessors of the 1960s and 1970s, that sought to replace the discipline of the market by socialist or centrally planned macro-organizational strategies."

It should be noted that subsidies that directly or indirectly encourage exports, and remedies for the damage they may cause to domestic producers in

[6] See Agosin and Ffrench-Davis (1993) for a contrast between the Asian experience with trade policy and the recent trade liberalization in Latin America.

[7] It is often forgotten that the market can also make very wasteful mistakes.

importing countries, have become a focus of contention in international trade negotiations. If successfully concluded, the new disciplines that will emerge as a result of the Uruguay Round include important restrictions on all but the poorest countries on the ability of developing countries to subsidize exports (Tussie, 1993; Ocampo, 1992). Therefore, greater care than in the past must be taken in the design of such policies.

Impacts of different policy packages on foreign direct investment

As can be seen in table 1, which presents a very selected sample of possible options, a wide variety of trade and investment policies can have an impact on the volume and quality of FDI flows. The table is purely illustrative, but serves to drive home the points that trade policy can have powerful impacts on FDI and that FDI policy can have powerful impacts on trade outcomes; and that both sets of policy tools need to be considered together. It should also be stressed that no measure, or group of measures, in and of itself, will encourage FDI in the desired quantity and in the industries preferred by policy makers. The attractiveness of a particular location to foreign investors depends on a large variety of factors, some of which are intangible (economic and political stability, for example) (UNCTC, 1992).

A very important set of variables refers to the macroeconomic environment. Macroeconomic stability, both internal and external, are likely to be important considerations to foreign investors. With regard to the exchange rate, it is an essential condition that its level be such that it makes production for export internationally competitive. It is also essential that extreme fluctuations in the real exchange rate be avoided. Such fluctuations discourage all investment for export markets, foreign and domestic alike.

In fact, FDI is likely to be even more fickle than domestic investment, because in most cases it has alternative sitings that domestic investors will not—or are not in a position to—consider. Thus, the conditions of macroeconomic stability and microeconomic competitiveness that must prevail are likely to be more exacting when it comes to foreign investments than what would be required for those of a purely domestic nature.

Institutional and legal arrangements and their stability are also essential determinants of the quantity and quality of FDI. In this regard, instruments such as the foreign investment regime and the institutional arrangements related to competition policy (the effectiveness of anti-trust laws, institutional supervision of the financial sector, consumer-protection mechanisms and environmental protection laws) are particularly relevant.

Table 1. Selected "old" and "new" trade and investment measures and probable impact on foreign direct investment

I. Measures affecting most-favoured-nation treatment

1. Trade agreements: Expanded market size for certain products and services; encourages FDI for regional markets.
2. Free trade agreements and common markets: Expanded market size for all products and services produced in the domestic economy; encourages FDI for regional markets and promotes inclusion by TNCs in the regional rationalization of production.

II. Measures affecting market access

Traditional border measures

3. Tariffs, quotas, technical standards, voluntary export restraints: Preserves the domestic market for domestic producers; encourages market-seeking FDI while discouraging labour-seeking and component-sourcing FDI; may discourage resource-seeking FDI, if exchange rate is overvalued as a result of import substituting policies.

Non-traditional "inside-the border" measures

4. Prohibitions to operate in domestic market: Preserves market for domestic producers.
5. Limited access to joint ventures: Preserves acquisition of technology and know-how for domestic producers; restricts market access to foreign producers; restricts FDI in services.
6. Full access to domestic markets for services producers: Encourages FDI in services; may contribute to technological and know-how diffusion if allied to "realistic" performance requirements and/or targeted incentives. May encourage labour-seeking, component-sourcing and resource-seeking FDI in service-using industries.
7. Visa requirements for temporary labour movements: Discourages FDI in professional and other services; preserves domestic market for national producers.
8. Obligation to use domestically produced inputs: Discourages FDI of all kinds.

III. Measures affecting national treatment

9. Full national treatment for all foreign investors: Encourages all FDI; may adversely affect national firms with reasonable prospects of becoming internationally competitive.

10. Preferential tax treatment for TNCs with certain attributes: Encourages FDI with desirable attributes (e.g., access to foreign markets, technology transfer).

11. Preferential tax treatment for TNCs in exchange for selected performance requirements: May contribute to upgrading of economy's international competitiveness through spillover effects; encourages FDI with desirable characteristics.

12. Discriminatory treatment for TNCs (special performance requirements not imposed on local firms and with no compensating incentives, barring access to domestic credit markets, government procurement, foreign exchange, or incentives available to domestic firms such as tariff drawback schemes or export subsidies): May discourage FDI in certain circumstances; however, may be necessary in economies with strong disequilibria or to compensate domestic firms for certain disadvantages in relation to TNCs (e.g., access to international credit markets, better access to export markets).

IV. Competitiveness-enhancing measures

13. Export Processing Zones: Encourages labour-seeking and component-sourcing FDI.

14. Export subsidies: Encourages labour-seeking, component- sourcing and (to a lesser extent) resource-seeking FDI; in certain cases, they may *discourage* export-oriented FDI (e.g., when they substitute for needed currency devaluation and when they are granted by Governments against which importing countries are expected to countervail).

15. Tariff drawback schemes: Encourages labour-seeking and component-sourcing FDI.

16. Stable exchange rate: Encourages all kinds of FDI.

17. Investment in physical and social infrastructure: Encourages all kinds of FDI; can be used as *quid pro quo* to attract desired FDI from specific companies.

The policy dilemma

The basic policy dilemma that developing countries have to face is that, on the one hand, the attainment of development goals may imply the need for some restrictions on the full sway of the principles of MFN and national treatment and on unfettered market access, while, on the other hand, TNCs are tending to favour increasingly the least number of such restrictions. Before the era of globalization, foreign affiliates were oriented towards serving domestic markets and favoured trade restrictions that reserved markets to them. Today, they are increasingly integrated into global or regional networks of firms. Therefore, they are considerably more footloose than they used to be, *and more footloose than purely domestic firms in host economies*. The implication is that economic policies (including trade policy) in host countries could have large effects on trade flows, FDI, employment and output, since they have decisive effects on the siting of TNC activity.

It may be true that the removal of barriers affecting market access and the granting of full national treatment would make countries far more attractive to foreign investors than those showing limitations in those areas. Yet two things should be taken into account:

- First, it is obvious that the mere removal of such barriers is not a sufficient condition for attracting FDI. Political and social stability, the quality of the labour force and of the physical infrastructure available in a country, its natural resource endowment, its geographical location and the size of its domestic market may all be factors at least as important as the degree of openness and deregulation prevailing in the country. In fact, the higher the rating a country shows with respect to these factors, the greater its bargaining power to extract development-enhancing performance from TNCs in exchange for market access and national treatment.

- Second, the free and unchecked movement of factors of production at the international level *does not* guarantee development *per se*. In fact, this is certainly not the case within national borders, where almost perfect mobility of goods, services and factors of production does not, automatically, solve domestic regional imbalances with respect to development. This is not only true in developing countries but in developed ones as well.

It is important then, to make explicit which are the objectives of a particular country wishing to become more integrated into the global economy. In other words, why do countries go global? This should help policy makers define what they expect from TNCs and how to calibrate the degree of market access and

MFN and national treatment each country wishes to grant to foreign products, services and factors of production.

Globalization and optimal foreign direct investment policies

Some of these considerations can be used in determining the exact content of the trade-cum-FDI policy mix. Of course, optimal policies are highly country-specific, and the notions developed below should be considered to be only illustrative. It is assumed that the objective of the country in question is the attainment of international competitiveness and it is orienting its trade and FDI policies accordingly. This section attempts to answer the question of how can FDI policies themselves support the attainment of this objective. The discussion will deal with general FDI and with FDI policies for specific industries.

Optimal FDI policies

As already noted, one characteristic of globalization is that it has increased the proportion of economic activity that is footloose (Dunning, 1992). Therefore, the optimal FDI policies in the era of globalization (in which there is intense locational competition for such investment) are those that are most transparent, non-discretionary and stable over time. As already noted, proscriptions tend to discourage all FDI. Likewise, case-by-case approvals of specific incentives and lengthy delays in investment approvals are likely to divert investments to neighbouring countries that are close locational substitutes. Frequent changes in the rules discourage investment.

With the exception of large investments (the size of which is determined on a country-by-country basis) and investments in industries which the Government wishes to promote (and, hence, which will receive privileged treatment), investment proposals should receive automatic approval. As regards industries in which FDI is permitted, use should be made of a negative list; the closed industries should be as few as possible. Transnational corporations should be able to remit their profits and even repatriate their investment (after a minimum period of, say, one to three years in order to discourage speculative capital flows) with ease. Joint venture requirements should be selective and restricted to certain strategic industries, where they can be used as a counterpart for higher-than-average incentives. These are undoubtedly the kinds of policies that allow TNCs to focus on the underlying economic rationale for investing in a particular country.

Should Governments offer investment inducements, such as tax rebates, outright cash grants or production or export subsidies? This is a difficult question to answer in the abstract, as it will depend on a variety of factors, not least what other competing countries are offering. In order not to engage in bidding wars that result in giving away to the investing corporations the rents that Governments expect will accrue to their countries, it is important that countries exchange information on their FDI policies, as a first step towards harmonizing them. This will be particularly important in countries establishing free trade arrangements. At any rate, generalized investment incentives should be moderate, for both budgetary considerations and in order not to shift the rents accruing from FDI to the investors.

Foreign investors with an orientation towards world or regional markets are more likely to be interested in the general policy framework for FDI and in *trade policies* than in investment incentives. These are being discussed in the next section.

Steering FDI into specific industries

The new trade theories suggest that there is ample scope not only for strategic trade policy in developing countries but also for strategic FDI policy—or, more generally, strategic investment policy, pure and simple, be it foreign or domestic. In fact, strategic trade policy has a large component of strategic investment policy: the orientation of investment resources to industries in which comparative advantage can be created or to activities that have large externalities for the economy as a whole or for parts of it, such that it is possible to create competitive clusters of activities over a reasonable period of time.

As regards FDI, strategic investment policy in developing countries boils down to three issues. The first one is whether investment incentives should be differentiated industry-wise. The second issue is whether incentives and performance requirements should be used to stimulate activities by TNCs that have large externalities (e.g., the training of skilled labour). The third issue revolves around the desirability of performance requirements (particularly of the export variety) as a way of steering TNCs towards export markets.

If a Government has identified specific industries or activities (for example, non-traditional exports or on-the-job training) it wishes to encourage through differentiated incentives, TNCs investing in them alongside domestic producers should be given national treatment, that is, they should be entitled to the same incentives. In some cases, TNCs are the only firms operating in these areas, and incentives amount, in effect, to preferential treatment for TNCs. Such encouragements are entirely justified and should form part of the panoply of policy tools of a Government in implementing a strategic trade and investment policy. However, such inducements should be moderate, their economic rationale should be clear and they should be offered to a small number of activities only. How to choose them depends on a host of country-specific factors. Knowledge of the intentions of other Governments that are potential competitors for FDI is also important for another reason: Governments in different countries should avoid encouraging investments in the same lines of production, thereby lowering international prices. Something of this phenomenon is in evidence in such industries as garments and steel, which are favoured by new entrants into international markets for manufactures.

This kind of industry-specific incentives merges with the incentives that would be appropriate to obtain certain kinds of behaviour from specific companies, for reasons of externalities. In both cases, the company and activity in question are usually identifiable. In most cases, the investors are international oligopolies that have proprietary technologies and products whose introduction into the domestic economy can have effects that go far beyond the benefits accruing to the factors of production directly engaged by the company. This is the case with most manufacturing products with complex technologies, but particularly those using information technologies. A special incentive for these companies may be entirely appropriate.

Industry- and activity-specific inducements to FDI can be usefully accompanied by performance requirements. For example, an incentive could be made conditional on the export of a certain proportion of output or on training programmes for domestic employees or managers.[8] In many cases, performance requirements can be implicit, since the foreign firm will have to apply for a special incentive not offered to all foreign investors and, in the process, it will have to disclose the nature of its operations in the country. This is a clear game-theoretic situation between dual monopolists, with the outcome determined by relative bargaining power. The more desirable the country as a location and the fewer the locational alternatives, the greater will be the possibility that the Government can shift oligopolistic rents from the company to the domestic economy and orient the foreign firm towards specific long-term development objectives.

Should performance requirements be used, in all or most cases, to steer TNCs to export markets? This issue has been amply researched recently in UNCTC-UNCTAD (1991). Export-performance requirements were more likely to be necessary when FDI was oriented mostly to domestic markets and when the inducement was mostly producing behind high trade barriers. In an era in which FDI is increasingly oriented towards global or regional markets

[8]An interesting example of this kind of behaviour is the agreement between the Government of Mexico and IBM whereby, in exchange for being allowed to set up an affiliate with 100 per cent ownership, IBM agreed, among other things, to set up facilities to train Mexican computer programmers (UNCTC, 1988, box IX.2).

and trade barriers in host countries are much lower, export-performance requirements are a less compelling policy tool. Moreover, performance requirements are a tool belonging to the proscriptive approach. Better results can be obtained by encouraging the establishment of firms that most likely will produce for foreign markets or introduce desired technologies.

An alternative is to blend performance requirements with specific incentives. In this option, there would be a general framework for FDI, with few limitations and requirements and no special incentives, and another one for companies with certain characteristics, which would be subjected to stiffer requirements but would also be rewarded with more generous incentives.

Another approach, which would skirt the problems of lengthy approvals, bureaucratic delays, case-by-case negotiations and having to apply different criteria to different investors (a process that lends itself to abuse) has already been mentioned: it is to adopt an automatic "performance-based" corporate tax system favouring a few specific activities and which gives equal treatment to national and foreign firms.

Concluding remarks

Clearly, the changing trade strategies of developing countries require a reconsideration not only of trade policy but also of investment policy, and particularly of policies towards FDI. If TNCs play an important role in the process of export expansion and diversification, it will not be sufficient to effect trade policy reforms while leaving FDI policy untouched. And in the area of services, trade and FDI policies merge. This is not to say that it is impossible to penetrate international markets without TNCs. But it will be certainly faster to use the medium of the TNC than deliberately to make do without them. Even arm's-length forms of relationship with TNCs such as subcontracting may require some investment.

Therefore, it will be useful for developing countries contemplating, or already implementing, a change in development strategy to consider the implications of the new strategy for FDI policies. In general terms, if the promotion of international competitiveness is the desired policy objective, then the more liberal and prescriptive are FDI policies the better. And, as already noted, trade and macroeconomic policies become just as important as FDI policies themselves. In addition, a strategic trade policy can be usefully complemented by a strategic FDI policy encouraging investment in industries and activities that promote the acquisition of new comparative advantages. ■

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