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Phedon Nicolaidis*

Multilateral Rules on Foreign Direct Investment

During the last decade the world stock of foreign direct investment has more than doubled. Nevertheless, considerable impediments to FDI continue to exist. The following paper discusses these and offers an answer to the question as to whether multilateral rules on FDI are necessary to remove these barriers and what form these rules could take.

Since 1986 trade negotiators at GATT have been attempting to define multilateral rules on Trade Related Investment Measures (TRIMs). As the term indicates, the negotiations have focused almost exclusively on the implicit barriers to trade which are caused by such things as local-content requirements and export requirements imposed on subsidiaries of foreign firms.¹ The negotiations have certainly not been about the freedom of entry or the right of establishment of foreign firms. Even the OECD code on foreign direct investment (FDI) deals mostly with the treatment of foreign firms after they are allowed to enter a national market.

The question which arises, therefore, is whether we need multilateral rules on the right of entry or establishment and what the scope and objectives of such rules should be. To answer this question it is first necessary to know what effects unrestrained FDI might have on host economies and whether it is possible that distortions in one country can be transmitted to another through FDI. The latter possibility provides a *prima facie* justification for retaining restrictions on foreign investment.

The objective of this paper is to examine what kind of barriers multilateral rules on FDI should aim to remove and what kind of restrictions they may permit. For this purpose, it assesses the main arguments for interventionist policies with respect to FDI. The paper does not attempt to derive a precise definition of such rules, nor does it consider the institutional structure that may be needed to apply those rules. The paper concludes that although there is little economic justification for barriers to FDI, national treatment of foreign direct investors may facilitate the

transmission of distortions from one country to another. One way to avoid this contingency is to utilise measures provided by domestic competition laws. Since, however, domestic competition rules cannot remove distortions that impede inward investment in foreign markets, complete liberalisation of FDI would in addition require adoption of common competition rules or at least stricter enforcement of existing rules. Before turning to these issues, the major characteristics of the recent explosive growth in direct investment and other cross-border corporate links will be reviewed.

If a single word could describe the international business environment in the 1980s, that word would be "globalisation". The phenomenon of globalisation is manifest in the ever-expanding web of production systems, ownership and cooperative arrangements that transcend national boundaries. During the last decade the world stock of FDI has more than doubled to reach a figure estimated to be between \$ 900 billion and \$ 1,400 billion. This unprecedented increase of FDI has several important characteristics.

First, its annual rate of growth has surpassed that of trade by a factor of three to four. By the end of the 1980s more than \$ 100 billion were invested every year. This growth rate, however, registered a decline in 1991 because of the general downturn in economic activity in most industrial countries. (Not only does FDI follow the business cycle, it also tends to overshoot it.)

Second, until the beginning of the 1980s a sizeable proportion of outward FDI from industrial countries used to go to developing countries. By the end of the 1980s most of

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¹ For an account of the negotiations see P. Hayes: *Foreign Direct Investment: Will the Uruguay Round Make a Difference?*, Royal Institute of International Affairs, London 1990.

industrial country FDI went to other industrial countries. A study by the US Department of Commerce estimated that in 1967 developing countries had received about 30% of the total stock of inward FDI. The same study found that by 1989 the developing country share had declined to 19%. Statistics on annual flows show a steeper decline. During the 1975-79 period developing countries attracted close to 25% of the world average annual inward flow of FDI. In 1989, their share dropped to 10%. These aggregate figures disguise the large variations in shares among developing countries. In the mid-seventies East Asian countries (Asian NIEs and ASEAN) received almost no FDI. By 1989 they attracted about 6% of total flows. By contrast, the share of Latin American countries shrunk from 13% to 4%.

Third, the majority of recent FDI has not been in manufacturing but in services. Between 1980 and 1988 there was a threefold increase in the stock of outward FDI in services from the United States, Britain, Japan, Germany and France. During the same period, the share of services in the total stock of FDI of those countries grew from 34% to 42%.² A considerable proportion of the increase in services FDI was due to Japan's investments. More than 70% of Japan's stock of outward FDI has taken place in non-manufacturing sectors (which also include real estate).

Causes of Growth of Direct Investment

Investment decisions are determined by the general economic climate, the host country policies and, naturally, the investor's corporate strategy. A notable feature of overseas corporate investment is that firms tend to imitate the actions of their rivals.³ In general, the volume of FDI rises when broad economic conditions are propitious, when exports become a less effective means of supplying a market and when local presence enables a firm to have access to the assets that give its rivals a competitive edge.⁴

Most of the empirical studies on FDI reach the same conclusion. In general, flows of direct investment correspond to the business cycle. Given that the economies of most industrial countries were booming in the 1980s, it is not surprising that FDI attained such a high

rate of growth during that period. But the conducive economic climate is only one explanation of FDI. There are other, equally significant explanations.

Liberalisation and deregulation in service sectors have also had a considerably positive effect.⁵ Since most services are less easily traded than goods, direct investment is by and large the most effective means of supplying a foreign market. Heavy regulation, however, impedes market entry. Not surprisingly, waves of direct investment follow episodes of dismantling or simplification of regulatory procedures.

Trade barriers can also stimulate FDI. A firm whose exports are restricted by trade measures would resort to direct investment in order to regain and even expand its foreign market share. Part of the Japanese manufacturing FDI to Europe and the United States has been intended to circumvent both perceived and actual trade barriers and has been encouraged as a means of reducing Japan's bilateral surpluses.⁶

As global competition intensifies and as locational advantages enjoyed by national firms are being nullified by inward FDI, companies that want to remain competitive internationally have to develop appropriate international strategies. An important component of such strategies is development of new technologies and access to technologies developed by other firms in other countries.⁷ Consequently, FDI is also intended to tap into the latest research results in other countries. This kind of FDI has been more prevalent in the chemical and pharmaceutical industries. Moreover, the increasing number of strategic alliances between global firms aim to reduce the costs and the risks of developing new technologies by allowing the partners to focus on those aspects of research that are closer to their core of competences.

Complementary Strategies

As mentioned above, one motive for FDI is to circumvent trade barriers. Since such investment naturally tends to replace lost exports, there is the belief that if foreign firms are encouraged to produce locally (either through monetary incentives or outright import restrictions) bilateral trade deficits would be reduced. Should FDI incentives be allowed as a means of correcting trade imbalances? Aside from the fact that FDI incentives can easily degenerate into subsidy wars, there is no

² D. Julius: *Foreign Direct Investment: The Neglected Twin of Trade*, Group of Thirty: Occasional Paper 33, Washington, DC 1991.

³ E. Graham: *Transatlantic Investment by Multinational Firms: A Rivalistic Phenomenon*, in: *Journal of Post Keynesian Economics*, Vol. 1, 1978, pp. 82-99.

⁴ See the review of the causes of direct investment in: S. Thomsen, P. Nicolaidis: *The Evolution of Japanese Direct Investment in Europe*, Harvester-Wheatseaf, London 1991.

⁵ D. Julius, *op. cit.*

⁶ M. Yoshitomi: *Japanese Direct Investment in Europe*, Avebury Press, London 1991.

⁷ J. Hagendoorn: *Organisational Modes of Inter-firm Cooperation and Technology Transfer*, in: *Technovation*, Vol. 10, 1990, pp. 17-30; OECD: *Industrial policy in OECD Countries: Annual Review*, Paris 1991.

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established inverse relationship between FDI and exports. For one thing there are many countries whose exports encounter foreign protectionism, yet they do not invest in foreign markets. The ability to undertake direct investment depends on whether the investor has assets that can be transferred to foreign markets. At a minimum, this presupposes ownership of intangible assets such as technology, superior production techniques or superior managerial techniques.

Because of the risks involved in direct investment (e. g. unfamiliarity with foreign markets), FDI usually follows successful export drives which serve to familiarise exporters with other markets. This is why the destination of exports and the destination of FDI are highly correlated.⁸ Once a firm secures an adequate market share through exports it may then establish local facilities which may reduce the costs of supplying the market, partly by replacing exports.

But for multinational firms which are at the forefront of new technologies, FDI does not simply replace exports. It only replaces the exports of those products whose technology is well known and whose production methods are standardised. Products depending on newer technology which is not yet fully developed and whose production techniques are not yet streamlined would tend to be manufactured in the home market where headquarters and research operations are usually based. Hence, even in the absence of trade impediments FDI and exports would tend to be complementary rather than alternative market-entry strategies.⁹

This is confirmed by the evolution of US FDI and exports to the European Community. American investment is a useful benchmark because it is old and, thus, it is less likely to have been affected by the completion of the internal market in the EC. As shown in Table 1, not only does American investment go to the main export markets, there is also a close correspondence between the proportion of FDI in each host country and the proportion of exports sent to those countries.

Responses to several surveys of multinational companies (MNCs) have also emphasised the importance of FDI as a means of consolidating market presence rather than for simply "jumping" over tariffs. In all the surveys reviewed in Thomsen and Nicolaidis¹⁰ circumventing trade restrictions is a frequent answer but never the most important. The top-ranking objective cited is the need to

produce close to consumers. As products become technologically more sophisticated and as competitiveness depends partly on the ability to differentiate one's own products from those of others, it is essential for firms to make their products meet as closely as possible the preferences of consumers and the requirements of clients. Moreover, investors have also tended to locate close to their main suppliers. Presumably, proximity improves coordination between suppliers and users. These developments imply that firms would invest in those industries in which they already have considerable experience and technological capacity. Japan's FDI confirms this relationship between FDI and export success. Table 2 shows the distribution of Japanese exports and stock of FDI in the EC in terms of industrial sectors. Japanese firms tend to invest in those sectors in which they are successful exporters.

Transfer of Technology

If FDI cannot be used as a means of correcting trade imbalances, then one may think that an alternative policy

Table 1
Distribution of US Investment and Exports to the EC

	Investment ¹	Exports ²
UK	30	27
Germany	19	19
France	13	12
Netherlands	10	10
Italy	9	10
Belgium	7	6
Ireland	7	6
Spain	5	6

¹ % of total US manufacturing FDI to the EC (1989).

² % of total US merchandise exports to the EC (1989).

Source: S. Thomsen and P. Nicolaidis: *The Evolution of Japanese Direct Investment in Europe*, London 1991.

Table 2
Sectoral Distribution of Japanese FDI and Exports to the EC
(in percent)

	Investment	Exports
Electrical equipment	27	38
Transport equipment	20	25
Other	13	17
Machinery	13	11
Chemicals	13	5
Textiles	6	2
Steels, metals	5	1

Source: see Table 1.

⁸ Cf. M. Yoshitomi, *op. cit.*

⁹ Cf. S. Thomsen, P. Nicolaidis, *op. cit.*

¹⁰ *Ibid.*

would be to impose restrictions or requirements on foreign firms in order to induce them to transfer technology into the host country. After all, a country's technological base is one of the main determinants of its comparative advantage. Indeed, MNCs are the primary sources of technological innovation. On the basis of the number of patents obtained in the United States, Patel and Pavitt¹¹ found that large firms (of more than 8,000 employees) accounted for close to 50% of all patents. In industries such as motor vehicles large firms were responsible for 62% of patents. Patel and Pavitt also found that other measures of technological innovation (namely, R&D expenditure) put the share of large firms about 25% higher.

Moreover, the most recent and most advanced technologies tend to move across borders through MNCs (either to subsidiaries or to joint ventures). Not only would MNCs be reluctant to make their latest innovations widely available, but they would also encounter problems in attempting to sell in open markets innovations which are either difficult to patent or not completely operational yet. Hence, complex technologies tend to spread geographically within MNCs without changing ownership. Evidence for this intra-firm dissemination of technology has been found by, among others, McFetridge.¹²

There is another, increasingly important reason why the cross-border flow of technology would tend to take place within MNCs. As technological obsolescence accelerates, the cost of basic research rises, competitiveness increasingly depends on having access to the latest research results and as more firms enter into cooperative research arrangements with their counterparts in other countries, an increasing proportion of technology would have to be shifted across frontiers and an increasing proportion of that shifting would be undertaken by MNCs.

Cross-border Alliances

As a result, there is hardly an MNC which has not signed some kind of collaborative venture with another firm in another country. Table 3 shows the number and types of collaborative agreements that were recorded in 1973-76 and 1985-88. The statistics in the table are likely to understate the true extent of cross-border cooperation

Table 3
Collaboration among Firms
(Number of international agreements)

	1973-76	1985-88
Joint ventures	64	345
Joint R&D	22	653
Technology exchange	4	165
Direct investment	29	237
Other	34	536
Total	153	1936

Source: J. Hagendoorn: Organisational Modes of Inter-firm Cooperation and Technology Transfer, in: *Technovation*, Vol. 10, 1990, pp. 17-30.

among firms because many agreements remain unreported.

Indeed, it appears that successful MNCs have adopted a strategy of specialisation in core competences coupled with an expanding network of cooperative arrangements which facilitate their absorption of new technologies and the creation of complementary technologies.¹³ Success seems to depend on the ability to fit one's own products into the range of existing and newly emerging technologies (i.e. imitation, modification, packaging of different technologies). The alternative strategy of creating unique technologies and standards does not seem to be either easier or cheaper.

Another explanation of why the web of cross-border alliances is expanding is provided by Patel and Pavitt.¹⁴ They argue that despite all the talk about globalisation, basic R&D appears to be predominantly carried out close to headquarters. That is, it is a home-country activity. Their empirical work, based on a sample of large firms, showed that only firms from the Netherlands and Switzerland did more than 20% of their patenting from locations outside their home countries. And only in Belgium did foreign firms contribute to more than 20% of the total number of patents. However, these results need to be interpreted carefully. It is possible that they are biased because they are based on the number of patents issued in the United States. Subsidiaries may tend to patent their innovations in the host country. Hence, their technological activities would not show up in American registers. Moreover, the patenting of inventions and innovations by subsidiaries may be the responsibility of parent companies, which they would naturally do in their home country.

¹¹ P. Patel, K. Pavitt: Large Firms in the Production of the World's Technology, in: *Journal of International Business Studies*, Vol. 22, 1991, pp. 1-21.

¹² D. McFetridge: The Timing Mode, and Terms of Technology Transfer, in: A. Safarian, G. Bertin (eds.): *Multinationals, Governments and International Technology Transfer*, Croom Helm, London 1987.

¹³ J. Cantwell: The Organisation of European Industries after Integration, in: *Journal of Common Market Studies*, Vol. 26, 1987, pp. 127-151; J. Cantwell, J. Dunning: MNEs, Technology and the Competitiveness of European Industries, in: *Aussenwirtschaft*, Vol. 46, 1991, pp. 45-65.

¹⁴ P. Patel, K. Pavitt, op.cit.

Nonetheless, there is ample anecdotal evidence that most R&D is undertaken in home countries. This has important implications for both public policy and corporate strategy. If the creation of technology is localised, does openness to FDI make a host country more vulnerable to "unfair" competition from countries which are less open? Is this problem remedied by requirements for reciprocity in FDI? Is it remedied by forcing foreign firms to do more of their manufacturing locally? Some of the arguments for imposing minimum local-content requirements on foreign firms are considered below.

Local-content Requirements

Such requirements are like a tax on production. Since they force foreign firms to alter their production plans, presumably they also force them to deviate from their profit-maximising strategy. To the extent that local-content requirements are expressed in terms of quotas of local inputs that have to be purchased by foreign firms they are also illegal under GATT because they discriminate against imported inputs after such inputs have entered the local market (they are supposed to be accorded national treatment).

Since local-content requirements are like a tax they make production in the host market a less attractive option for supplying that market. This implies that exporting directly from the foreign firm's home market becomes a more attractive option. This is the reason why local-content requirements are accompanied by trade restrictions. Hence, an assessment of the effects of these requirements would be incomplete without taking into account the effects of trade barriers that support them. The two kinds of measures taken together move a country closer to autarky. Although an individual country (especially a large one) may gain at the expense of other countries it is clear that trading countries as a group become worse off.

This is the effect we would expect in a static context. Local-content requirements are also favoured because of their perceived dynamic effects (externalities from local manufacturing, technology transfer, demonstration effects, etc.).¹⁵ Whether dynamic benefits outweigh static costs is an empirical issue that cannot be settled a priori. But if externalities and other dynamic effects can be substantially increased through local-content requirements why should they apply only to foreign firms?

A case in point is the automobile industry. In the EC

there has been a political dispute, involving Britain and France, concerning the local content of Nissan cars. The issue of dispute was whether 80% local content was adequate to identify Nissan cars as European. By the mid 1980s, however, the UK content of established manufacturers had fallen to about 45% for Ford and Talbot and 25% for Vauxhall.¹⁶ In the United States there is also a downward trend in the US content of cars made by US manufacturers. Similar changes have occurred in other industries such as consumer electronics, computers and semiconductors. European and American producers have responded to competitive pressure from East Asian firms by sourcing abroad and by doing more assembling and manufacturing abroad.

In a world where some national firms are as multinational as foreign firms there is little rationale for discriminating on the basis of nationality. The question, therefore, arises whether countries should instead aim to remove foreign restrictions to FDI so that competition between MNCs becomes fairer.

FDI in Japan

The countries with the largest investments have a rough parity between inward and outward FDI. For example the ratio of outward to inward FDI during the 1980s was 0.6 : 1 for the United States, 2:1 for the UK, 2:1 for the Netherlands, 5.5 : 1 for Germany and 1.5 : 1 for France. The exception was Japan, whose ratio was 33 : 1. Inward FDI in Japan is miniscule compared to its massive outflow.¹⁷

However, this gap becomes smaller when a longer time period is examined. Over the 1950-89 period the stock of FDI in Japan was \$ 15.6 billion, half of which originated in the United States. During the same period, Japan's FDI in other countries had reached \$ 254 billion (hence, a 16 : 1 ratio). The difference in the two ratios is probably the result of early inward investment from the United States. The fact that the gap is wider over the more recent period is not very surprising.

Despite the removal of virtually all restrictions to FDI, in the 1980s Japan became a prohibitively expensive location for investment. The prices of land, capital, labour and the yen registered multiple appreciation. Japan was also a tough market. Consumers and users of industrial products were demanding high-quality standards and expected continuous improvements in performance and steady reductions in price.

¹⁵ It should not be forgotten that the most vociferous proponents of local-content and other performance requirements are import-competing industries which understand that these requirements have a protectionist element.

¹⁶ Cited in J. Cantwell, J. Dunning, *op. cit.*

¹⁷ Cf. M. Yoshitomi, *op. cit.*

Foreign firms, however, have also complained of adverse discrimination. Some of the more serious complaints have identified Japan's "keiretsu" system of corporate groupings as a major obstacle to inward investment. The foreign view is that keiretsu members prefer to do business among themselves. The Japanese view is that long-term relations are indispensable to a firm's ability to undertake long-term investments, maintain the quality of bought components and ensure effective distribution of final products.

Japan is not the only country with impediments to FDI. For example, other countries have restrictions on the takeover of publicly quoted companies. It just happens that Japan with its competitive companies has highlighted imbalances in FDI. The issue which arises is whether there should be reciprocity requirements imposed on foreign investors. To answer this question we need to know how countries which demand reciprocity would be affected by a possible reduction in inward FDI. We also need to know the effect on them of absence of any reciprocity restriction (i. e. unimpeded FDI).

Reciprocity

What is the purpose of reciprocity? Presumably its aim is to force other countries to remove their restrictions so that non-national firms could derive whatever benefits are enjoyed in the domestic market by national firms. But in most cases foreign firms cannot survive the competition in foreign markets unless they already have unique assets (including technology) of their own. Removal of restrictions does not by itself make firms able to withstand the rigours of competition. If potential foreign investors have a strong technological base of their own, would they encounter any difficulty in investing, particularly when the impediments are informal rather than legal? It is unlikely that Japanese firms, for example, would be unwilling to cooperate with a foreign firm which is at the cutting edge of technology.

While reciprocity in investment does not necessarily improve a country's competitiveness, it can seriously harm it by obstructing inward investment. MNCs transfer a considerable amount of know-how and skills even when their subsidiaries undertake no substantial R&D in host countries. Training of personnel and quality controls of component suppliers are some of the beneficial effects of FDI.

Of course, FDI also puts competitive pressure on rival local firms. A common concern about FDI is that it undermines local firms which employ skilled personnel. In the end, it is argued, local high-skill workers are displaced by low-skill workers employed in the assembly of foreign

products. This indeed may be a consequence of FDI. But it cannot be avoided by demanding reciprocity. The local firms which cannot compete with the foreign firms because they are technologically backward will not be able to benefit from unrestricted access to the home markets of the foreign investors. As explained by Cantwell¹⁸ the negative effect of FDI on local skills and know-how is more likely to occur when the host country is already weak. Therefore, if it is the technological capacity of the host country which is at the root of the problem, a more effective long-term remedial policy would aim to strengthen that capacity directly rather than impose restrictions on foreign firms.

This does not mean that discriminatory measures in other countries should be ignored. Such measures should be identified as precisely as possible and their removal should be negotiated rather than demanded through blunt instruments such as reciprocity requirements which usually identify flows and stocks (determined by many other factors apart from impediments to FDI). But, multilateral removal of impediments to FDI is even better than attempts at gaining market entry through bilateral negotiations. The impediments that should fall within the purview of a multilateral regime on FDI are identified below.

The flow of FDI is frequently obstructed not by overt barriers but by anti-competitive practices. Countries which have no legal restrictions on FDI may attempt to tilt the playing-field in favour of their own firms by not enforcing competition rules as strictly as they could possibly do. There is a rising concern that countries which tolerate uncompetitive practices make inward FDI more difficult and outward FDI unfairly competitive.

Competition

FDI would have an adverse effect on competition if the foreign firm achieved a dominant market position by taking over its local rivals. Presumably this contingency can be prevented from arising by the normal competition provisions on mergers and monopolies. Therefore, the anti-competitive elements of FDI that cause concern are those which fall outside the scope of domestic competition law.

What takes place in the foreign market and affects exclusively the foreign market is clearly outside the scope of domestic law. The foreign government that tolerates collusive and monopolising practices (e. g. exclusive distribution arrangements) makes inward FDI more

¹⁸ J. Cantwell, *op. cit.*

difficult. It also makes its market more attractive because prices are higher as a result of the anti-competitive practices. Currently, there are no multilateral rules for dealing with this kind of obstruction to trade and investment. The only available option is the threat of unilateral retaliation or bilaterally conducted negotiations.

Foreign anti-competitive practices may also affect the domestic market (e. g. by managing or targeting exports to it). In this case, American anti-trust law and EC competition law claims extraterritorial jurisdiction and penalises the companies involved even if they are based in other countries. An example of this extraterritorial reach was the 1991 review of Matsushita's (based in Japan) takeover of MCA (based in the US) by the EC competition authorities.

But the extraterritorial application of national rules is an imperfect substitute for international rules. Different countries have different legal traditions, different corporate practices and different views on how firms should behave. Extraterritoriality means that one country imposes its system on other countries and that firms involved in international markets have to satisfy the rules of more than one country simultaneously (double or triple jeopardy). It may so happen that extraterritorially enforced rules have a net positive effect on efficiency and global welfare. This is not the only possible outcome. Other outcomes may worsen global welfare. A better approach to problems of global competition would be to have global competition rules.

Perception of Unfairness

Since such rules do not exist yet, host countries are left with the problem of how to treat foreign firms which may be competing legally but "unfairly". Examples of perceived unfair competition range from institutionalised obstacles to hostile corporate acquisitions to market regulation (requirements for compliance to particular rules have been branded as unfair even when these rules are non-discriminatory), close relations between manufacturers and suppliers of capital (i. e. banks), obedient labour unions (believed to be exploited by employers) and guidance by government departments.

The case of barriers to takeovers is worth examining more closely because for the purposes of this paper such barriers have a direct affect on FDI while other possible anti-competitive practices are likely to have only an indirect effect. Competition is believed to be unfair when some companies are bid-proof. Although it is doubtful that this is a competition problem in the conventional sense of the word, it is also doubtful that this perception is correct. For one thing, even bid-proof companies operate under

certain constraints, some of which may be more stringent than those that affect more open companies. For example, bid-proof companies may be under strict control by banks, major shareholders, etc. Moreover, even bid-proof companies would still have to pay a price in order to acquire another company. If their being bid-proof is some kind of advantage that enables them to get more value out of the acquired company, the stock market would adjust its price upwards. The foreign investor would end up paying more. Finally, if being bid-proof confers an unambiguous advantage what is there stopping companies from incorporating themselves in countries that permit such defences? The fact that there is no rush to establish holding companies in Germany, Japan or Switzerland is instructive.¹⁹

This is not to say that FDI's impact on competition should be ignored. It should only be put in perspective. Some problems such as collusive practices can be largely addressed by properly enforced domestic competition law. Other problems stemming from issues such as takeover conduct can only be resolved through policy reform and change in prevailing rules and laws. But some perceived unfair advantages such as obedient workers probably hardly exist because they get compensated in other ways (e. g. guaranteed employment) which offset those advantages.

Justifiable Restrictions

It has been argued above that, first, cross-border investment and corporate links are increasing. Second, FDI is more likely to strengthen a host country's technological capability rather than weaken it and, as a consequence, restrictions on FDI are more likely to undermine a country's competitiveness. Third, there is little justification for imposing more onerous regulations and obligations on foreign firms.

It follows from these arguments that FDI should be free of restrictions. In tangible terms, this implies that firms, irrespective of nationality, should, in general, have the right of entry or establishment and that they should be accorded national treatment. The statement in the previous sentence is qualified with the words "in general" because there are instances in which both the right of establishment and the right to national treatment may be justifiably withheld or modified.

There are two broad categories of cases which may justify restrictions. The first is that of distinct or

¹⁹ For a more elaborate analysis of the effects of restrictions to takeovers see P. Nicolaidis: Investment Policies in an Integrated World Economy, in: *The World Economy*, Vol. 14, 1991, pp. 121-137.

incompatible national regulations. The experience of the EC in its attempt to create a single internal market in services is instructive. Complete liberalisation has had to be preceded by some regulatory harmonisation. It is important to note, however, that incompatible national regulations do not justify different or in any other way discriminatory treatment of foreign firms. Although a foreign firm would have to gain authorisation before it is permitted to enter a market, it should still receive the same treatment as national firms seeking to enter the same market.²⁰

The second category of cases in which even national treatment may have to be modified stem from conflicting national rules on competition. As explained in the previous section, differences in rules on takeovers are unlikely to be a major problem (or one that can be resolved without harmonising national business laws—a task that cannot be attempted on a multilateral basis). The real problem is caused by differences in permissible corporate conduct. If a country tolerates practices which subvert competition in its own market, the entry of foreign firms can be made significantly more difficult. Such practices are normally outside the extraterritorial reach of competition laws such as those of the United States, the EC, Britain and Germany. These laws, however, can deal with foreign inward investment that threatens to damage competition in their own domestic markets as a result of existing distortions to competition in the country of origin of the foreign firm. Hence, the problem is the implicit or indirect barriers to investment into foreign markets which are dominated by a single or a few firms.

There exists a large literature on how the conduct of dominant firms can discourage entry, and thus investment, by other firms, especially when potential competitors are from another country.²¹ The only remedy is for the government to take action to curtail the abusive behaviour of dominant firms and to remove any structural obstacles to the entry of new firms (e. g. exclusive licences, exclusive control of networks, etc.). Such action may also necessitate changes in prevailing national laws.

Three Conclusions

If the foregoing arguments are correct they lead to three important conclusions. First, multilateral rules should aim to remove barriers to entry and discriminatory provisions on the treatment of foreign firms. Attempted levelling of the

playing-field (e. g. through reciprocity requirements) is hardly necessary and, in addition, it runs the risk of being ineffective at a multilateral level because it is difficult, if not impossible, to define the meaning of a level field in terms of simple rules.

Second, and perhaps somewhat paradoxically, distortions to cross-border investment cannot be completely eliminated simply by removing obstacles to investment. It is also necessary to initiate regulatory convergence and to curtail possible anti-competitive practices by dominant firms in host countries.

Regulatory convergence is a task that can be effectively accomplished on a sector by sector basis. Control of anti-competitive practices requires detailed definition of what constitutes anti-competitive behaviour.

Third, neither of the above tasks can be achieved in the absence of the appropriate international institutional framework. A multilateral body would have to be established with power to propose regulatory reform, monitor members' policies and decide whether these policies are discriminatory. A complete removal of barriers to investment would eventually imply that member countries concede a considerable amount of their economic sovereignty.

Final Remarks

Direct investment, like trade, brings national economies closer together. Firms can no longer retreat into protected national markets. Survival even within national markets requires competition against foreign firms operating possibly within the host country's tariff wall. As a result, there is an increasing number of cross-border corporate alliances and cooperative arrangements intended to strengthen firms by improving their ability to innovate and by extending their capacity to absorb technologies produced in other countries. Consequently, the national origin of both firms and products is becoming increasingly blurred.

These developments make it even less justifiable to promote particular firms and discriminate against other firms on the basis of their national origin. In addition to the difficulty of selecting national champions, the process of globalisation makes it unlikely that there are any firms left which can qualify as purely national.

As national economies become more integrated, the distorting effects of domestic policies become more visible. The best way of eliminating these distorting effects is through multilateral rules that remove restrictions on investment and curtail anti-competitive practices.

²⁰ It should also be noted that when markets are regulated there can never be any absolute assurance that nationality has no influence on the decisions of regulators.

²¹ See e.g. P. Nicolaidis: *Predatory Behaviour*, mimeo, European Institute of Public Administration, 1992.